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No. 07-

IN THE

Supreme Court of the United States

STAFF IT, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

In addressing whether "reasonable cause" exists to justify abatement of penalties based on an employer's failure to pay payroll taxes under 26 U.S.C. § 6651(a)(2) or its failure to deposit payroll taxes under 26 U.S.C. § 6656(a), where undue or financial hardship is alleged, should courts apply a test that takes into consideration all of the facts and circumstances in conformity with standards adopted by Treasury Regulations 26 C.F.R. §§ 301.6651-1, 301.6656-1 and 1.6161-1(b), and by the Second, Third, Seventh and Ninth Circuits?

CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 29.6 of this Court's rules, Petitioner Staff IT, Inc. ("Staff IT") states that it has no parent, and no publicly held company owns 10% or more of its stock.

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Staff IT, Inc. respectfully petitions this Court for a Writ of Certiorari to review the judgment entered and filed by the United States Fifth Circuit Court of Appeals on March 22, 2007.

OPINIONS BELOW

The opinion of the United States Fifth Circuit Court of Appeals is reported beginning at 482 F.3d 792. Pet. App. 1a-21a. The Memorandum and Opinion of the United States District Court of the Southern District of Texas granting the United States' Motion for Summary Judgment is not officially reported, although it can be found at 2006 WL 314440; it is reprinted at Pet. App. 22a to 43a.

STATEMENT OF JURISDICTION

The judgment of the United States Fifth Circuit Court of Appeals was rendered entered and filed on March 22, 2007. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 2101(c).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

This case involves a question of the law of federal taxation. The relevant statutory provisions are Internal Revenue Code (26 U.S.C.) §§ 6651(a)(2), and 6656. The relevant regulatory provisions are 26 C.F.R. §§ 301.6651-1, 301.6656-1, and 1.6161-1, the pertinent parts of which, along with other statutes and regulations cited are set forth in the Appendix.

STATEMENT OF THE CASE

Statute and Regulations. Employers are required to withhold federal personal income taxes, Old Age and Survivors, and Disability Insurance (hereinafter referred to as "social security") taxes and Hospital Insurance (hereinafter referred to as "Medicare") taxes from the wages of each employee, and to pay them over to the Internal Revenue Service (hereinafter "IRS"). These funds are often referred to as "trust fund taxes" because they constitute a trust in favor of the IRS from the time the employer deducts them from the employee's wages, and the employer is liable to remit them directly to the federal

government.[1] Social security taxes are taken out at a 6.2% rate[2] of an employee's wages, Medicare taxes at the rate of 1.45%,[3] and the amount of federal personal income taxes withheld from wages varies from employee to employee. In addition, employers must match the amount of social security and Medicare taxes deducted from their employees' wages and pay these additional amounts to the IRS;[4] however, these amounts are not considered "trust fund taxes" because they are a liability owed by the employer directly to the federal government.[5] Nevertheless, the expressions "employment taxes" and "payroll taxes" are synonymous and embrace both trust fund taxes and non-trust fund taxes combined.

Employers are required to deposit payroll taxes with the IRS via banks, and in many cases transmit them electronically; deposits must be made monthly, or semi-weekly or even sometimes daily, depending upon the amount of the payroll taxes collected. Because payroll taxes are imposed as a percentage of an employee's salary, these taxes (along with the burden of making timely deposits) increase as salaries increase and more employees are hired. Taxpayers failing to stay current with payroll tax return filing, payment and deposit rules face an array of stringent penalties (along with interest charges).

Petitioner Staff IT concedes it owes payroll taxes (including the trust fund taxes) themselves. The Company's liability for the taxes themselves and the interest on those taxes is not at

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1. Internal Revenue Code (26 U.S.C.) § 7501(a), Pet. App. 52a. Unless otherwise noted, all statute references herein are to the Internal Revenue Code (26 U.S.C.). *Slodov v. United States*, 436 U.S. 238, 98 S.Ct. 1778 (1978).

2. § 3101(a), Pet. App. 45a.

3. § 3101(b)(6), Pet. App. 45a.

4. § 3111(a) and (b)(6), Pet. App. 45a. This matching contribution is at the same rates, and is sometimes referred to as "the employer's share" of social security and Medicare taxes paid to the IRS.

5. *See, e.g., Brewery, Inc. v. United States*, 33 F.3d 589, 593 (6th Cir. 1994).

issue in this case.[6] Furthermore, although penalties for *late filing* of payroll tax returns[7] were at issue below, Petitioner concedes that issue in this Petition.

What remains in this case is Staff IT's liability for the two remaining employment tax penalties, namely late *payment*[8] and late *deposit* of payroll taxes.[9] In turn, the Company's liability for those two penalties depends upon the legal standard that a taxpayer must meet in order to show that it. financial hardship

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6. The IRS has two formidable provisions to collect the payroll taxes themselves, other than penalties. While neither provision is at issue here, they are worthy of note. The first is the "Trust Fund Recovery Penalty," which imposes personal liability upon every officer, director, employee and stockholder personally involved in an employer's decision not to pay the "trust fund taxes" to the IRS on time. § 6672(a), Pet. App. 51a. This provision acts not as a penalty, but instead makes individuals personally liable for a corporate employer's late payments and deposits. This personal liability may not be discharged in bankruptcy, 11 U.S.C. §§ 523(a)(1)(A) and 507(a)(8)(C), Pet. App. 44a. The IRS has 10 years from the date of assessment to pursue such individuals if it files a lien. § 6502(a)(1), Pet. App. 47a. The second weapon in the IRS' arsenal is its power under § 7402(a), Pet. App. 51a to enjoin employers and persons in control of them from *future* payroll tax violations, on pain of fines and imprisonment. *See, e.g., Fifty Below Sales and Marketing, Inc. v. United States,* 2006 WL 1228890, CCH 2006-1 USTC ¶ 50,345 (D.C.Minn. 2006). Again, the liability and collection of the payroll taxes themselves (whether from Staff IT or from persons responsible for their late payment) is not at issue here, only the penalties for failure to pay and to deposit.

7. § 6651(a)(1), Pet. App. 48a (late filing and failure to file). The penalty is 5% of the amount owed each month the return is late, with a 25% maximum.

8. § 6651(a)(2), Pet. App. 48a (late payment and failure to pay). The penalty is 1/2% of the amount owed each month the payment is late, with a 25% maximum.

9. § 6656(a), Pet. App. 49a (late deposit and failure to deposit). The penalty is 2% for deposits late less than 6 days; 5% for deposits between 6 and 15 days late; and 10% for deposits more than 15 days late. Under certain circumstances, the penalty can be increased to 15%. §6656(b), Pet. App. 49a-50a.

justifies their abatement or removal. In this Petition, Petitioner asks this Court to determine what that legal standard is. Such a determination is a question of law, not merely a question of fact.[10]

Penalties are imposed for late payment and late deposit of payroll taxes "unless it is shown that such failure is due to reasonable cause and not due to willful neglect."[11] The taxpayer must show *both* reasonable cause and the absence of willful neglect; if reasonable cause is absent, it is unnecessary to examine the issue of willful neglect.[12] The late payment and late deposit penalty statutes (and, for that matter, the late filing statute) contain the same "reasonable cause and not willful neglect" language.[13]

The expression "reasonable cause" is defined in the regulations, but "willful neglect" is not.[14] (Because the Fifth

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10. *United States v. Boyle*, 469 U.S. 241, 249 n.8, 105 S.Ct. 687 (1985).

11. § 6651(a)(2), Pet. App. 48a (late payment and failure to pay); § 6656(a), Pet. App. 49a (late deposit and failure to deposit).

12. Where taxpayers have been found not to possess reasonable cause, the courts have not addressed the subject of willful neglect, *e.g.*, *Fran Corp. v. United States*, 164 F.3d 814, 819 (2d Cir. 1999); *Staff IT, Inc. v. United States*, 482 F.3d 792, 802 n.34 (5th Cir. 2007), Pet. App. 20a. Where the taxpayer prevailed, however, willful neglect is addressed. *East Wind Industries, Inc. v. United States*, 196 F.3d 499, 508-509 (3d Cir. 1999).

13. §§ 6651(a)(1), 6651(a)(2) and 6656, Pet. App. 48a-50a.

14. This Court defines "willful neglect" as "a conscious, intentional failure or reckless indifference" and holds that a taxpayer must show that its lack of timely filing was the result "neither of carelessness, reckless indifference, nor intentional failure." *United States v. Boyle*, 469 at 245, 246 at n.4, 105 S.Ct. 687, 690 n.4. The U.S. Supreme Court's analysis in *Boyle* addressed penalties for failure to file tax returns under § 6651(a)(1), Pet. App. 48a. The "willful neglect" language in the statute enunciating the standard for failure to file a return is identical to the "willful neglect" language in §§ 6651(a)(2) and 6656 for failure to pay and to deposit, Pet. App. 48a-50a. This Court's *Boyle* analysis of "willful neglect" under the (Cont'd)

Circuit determined it unnecessary to address the presence or absence of "willful neglect" in Petitioner's case[15] we will not discuss "willful neglect" further.)

In practice, "reasonable cause" encompasses a variety of fact situations. However, this case involves the financial hardship addressed in the regulations where a taxpayer is unable to pay or deposit its payroll taxes on time because it would have suffered "undue hardship" had it done so.[16] The regulation construing the penalty for late payment includes undue hardship as one of the "reasonable cause" grounds.[17]

How does one determine whether an undue hardship (or financial hardship) exists sufficient to excuse penalties? The income tax and employment tax regulations provide no working examples explaining financial hardship, outside of the definition cited. However, as noted, financial hardship is only one category of "reasonable cause." That means that, as with all other fact patterns which fit under the heading of "reasonable cause," one looks to the general definition of "reasonable cause" in the late payment regulation; there, one is told to apply an "ordinary business care and prudence" test based on all of the taxpayer's individual facts and circumstances.[18] Since those general terms cover "reasonable cause" as a whole, they apply also to undue hardship: like everything else under the "reasonable cause" heading, one is to look to facts and circumstances.[19]

(Cont'd)
late filing penalty of § 6651(a)(1) is, therefore, applicable to both the late payment penalty under § 6651(a)(2) and the late deposit penalty under § 6656, Pet. App. 48a-50a. *Fran Corp.* 164 F.3d at 816, n.2; *East Wind* 196 F.3d at 504, n.5; and *Staff IT*, n.17, Pet. App. 13a.

15. *Staff IT*, Pet. App. 20a, n.34.

16. 26 C.F.R. § 301.6651-1(c)(1), Pet. App. 54a-55a and 26 C.F.R. § 1.6161-1(b), Pet. App. at 58a.

17. 26 C.F.R. § 301.6651-1(c)(1), Pet. App. 54a-55a, cross referencing 26 C.F.R. § 1.6161-1(b), Pet. App. 58a.

18. 26 C.F.R. § 301.6651-1(c)(2), Pet. App. 55a-56a.

19. 26 C.F.R. § 301.6651-1(c)(1) and (2) (Pet. App. 54a-56a) are under the definitional heading "reasonable cause", which applies to (Cont'd)

The late *deposit* regulation does not mention undue hardship. (Although the IRS will waive the late deposit penalty if it is "inadvertent" based on all the facts and circumstances, the late deposit must occur in a taxpayer's initial quarter; here, by contrast, Staff IT had been making payroll tax deposits for several years.)[20]

Even though financial or undue hardship is mentioned as a ground in the late payment regulation but not specifically in the late deposit regulation, courts apply the same analysis to both late payment and late deposit situations where financial hardship is alleged to exist.[21] This approach is logical where the same financial hardship prevents timely payment and deposit of payroll taxes.

To summarize, the tax statutes excuse penalties for late payment and late deposit of payroll taxes if the taxpayer shows "reasonable cause and not willful neglect." The statutory expression "reasonable cause" is defined generally in the

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(Cont'd)
26 C.F.R. § 301.6651-1(a)(1) and (2) (late filing and late payment regulations, respectively) , Pet. App. 53a.

20. 26 C.F.R. § 301.6656-3(a)(1)(i), Pet. App. 57a. The Fifth Circuit declined to decide whether this "inadvertent" standard is identical to the "ordinary business care" standard in the late filing and late deposit penalties in §§ 6651(a)(1) and (2), Pet. App. 48a, Pet. App. 16a, n.24. In any event, this "inadvertent" standard is irrelevant here since by its terms, it applies only to a depositor's first payroll tax quarter. 26 C.F.R. § 301.6656-3(a)(1)(iii), Pet. App. 57a.

21. *See, e.g., Fran Corp.* 164 F.3d at 815, 818, 820; *East Wind* 196 F.3d at 501, 508 513; and *Staff IT*, Pet. App. 16a. Financial hardship is a single category within the "reasonable cause" element; in evaluating the presence of "reasonable cause," late filing fact patterns on the one hand are often evaluated differently under that test than late payment and late deposit fact patterns are, on the other, *e.g., Fran Corp.*, 164 F.3d at 816, n.4, and *Staff IT*, Pet. App. 13a-16a. By contrast, all three fact patterns of late filing, late payment and late deposits are evaluated the same where the "not willful neglect" element is under consideration. *Boyle*, 469 U.S. 241 at 245, 246, n.4, 105 S.Ct. 687, 690 n.4; *Fran Corp.* 164 F.3d at 816, n.2; *East Wind* 196 F.3d at 504, n.5; and *Staff IT*, Pet. App. 13a, n.17.

regulations as the "exercise of ordinary business care and prudence." To determine whether this business care and prudence test is met, one examines all the facts and circumstances in the fact pattern. There are many separate and independent fact patterns that can constitute "reasonable cause" to excuse penalties, and all involve the business care and prudence test, which in turn is based on facts and circumstances. One of those separate and independent fact patterns recognized (and defined tersely in the regulations) is "undue hardship" or financial hardship. This financial hardship ground is what this case is about.

The statute governing employment tax penalties and undue or financial hardship has been part of the income tax and payroll tax law since 1954, although the statutory language "due to a reasonable cause and not due to willful neglect" has been in the tax statutes for 90 years.[22] The regulations mentioned above have not been changed since at least 1973, and the "undue hardship" regulation itself has not been amended since 1960.[23]

Facts of the Case. Petitioner Staff IT seeks guidance from this Court on the proper law to be applied in financial hardship situations, not a factual ruling. However, Petitioner's facts represent a case study of financial and business problems converging with the September 11, 2001 terrorist attack and the Enron bankruptcy to create a "perfect storm" of financial hardship.

Staff IT is a Texas corporation based in Houston, formed in 1996 as a personnel staffing company specializing in providing computer programmers and other technical personnel ("contractors") to outside businesses ("clients"). Mr. Rick McMinn is its president and 40% shareholder.

Clients would engage Staff IT to fill vacancies in computer programmer or other technical positions. Contractors hired by Staff IT would be placed on Staff IT's payroll, but would work under the designated client's direction. Each pay period, Staff

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22. *Boyle*, 469 U.S. at 245, n.3, 105 S. Ct. at 690, n.3 (1985).

23. *Fran Corp.* 164 F.3d at 818.

IT would pay the contractors their net compensation after withholding income and social security taxes, along with health insurance and other benefits that clients required Staff IT to carry. In turn, Staff IT would invoice the client for the contractors' services, including an amount that would cover its financing costs and leave room for the firm's fee.

Clients would usually pay Staff IT within thirty to ninety days after being invoiced. This required Staff IT to carry or finance its costs between the time it paid its contractors and the time the clients paid the Company. Some of the working capital needed came from Staff IT's officer-stockholders, but Staff IT still had to borrow a significant portion of its working capital from financial institutions.

As a relatively small business with lots of receivables, but no "hard" assets such as land, buildings, equipment, or manufacturing facilities, Staff IT was not able to borrow from traditional banks. Thus, Staff IT's only source of working capital was financing companies ("factors" or "factoring companies"). In the factoring process, a business sells its accounts receivables to a finance company at a discount. Then, as the business collects its receivables, it repays the factor, or arranges for the client to do so.

It was absolutely essential that Staff IT have an adequate and steady line of credit to stay in business. In mid-2001, Staff IT's factor was Prinvest Capital Corp. ("Prinvest"), a factoring company. By then, Staff IT employed more than two hundred contractors, and enjoyed a monthly cash flow of over $2 million. Through the end of September, 2001, Staff IT timely filed, paid, and deposited its payroll taxes.

During the summer of 2001, Staff IT experienced a series of financial setbacks. Its largest client, Compaq Computer, laid off a significant portion of its workforce, including 55 of its 106 Staff IT contractors, costing Staff IT $400,000 in revenue. In response, Prinvest refused to finance any more of Staff IT's receivables, declaring bankruptcy in August. This left Staff IT with no financing source, because it had no "back up" factor. (This is because factoring companies insist on using all of a borrower's assets as collateral to

prevent competing factors from stealing their customers; a competitor is deterred from financing a potential borrower with nothing left to put up as collateral.) Staff IT began negotiations with another factor to replace Prinvest; it was just about to sign an agreement when the September 11, 2001 terrorist attacks took place. The deal fell through during the period of financial uncertainty that followed. Despite all this, Staff IT stayed current with its payroll tax deposits.

In October 2001, Prinvest demanded $400,000 from Staff IT, and threatened to choke off Staff IT's cash flow by calling in all of its receivables unless it received the money right away. Mr. McMinn felt confident enough about the Company's future that he borrowed $300,000 against his home and loaned the money to Staff IT to help it pay the factor. Staff IT could not make any tax deposits in October. Had it paid the IRS instead of Prinvest, the Company would have been out of business within two weeks. During this time, Staff IT cut costs, deferred payments and redeployed employees to boost marketing efforts. Staff IT had just signed new contracts with two large corporations, and a deal with Dynegy Corp. looked promising.

These hopes were dashed in part when Enron, one of Staff IT's large corporate clients, filed for bankruptcy in December, 2001. Staff IT lost approximately $450,000 in receivables as a result. Worse, Staff IT still had not located a new factor, due to the climate after 9/11 and now, Enron. It could not make any payroll tax deposits in either November or December 2001. Had it paid the IRS in full at that time, Staff IT would have depleted its cash supply in November. To conserve cash, the Company delayed debt payments and payments to third party contractors. By year-end, Staff IT owed over $180,000 to third party contractors and attorneys, in addition to what it owed the IRS.

Staff IT did not cut the number of contractors on its payroll to reduce payroll taxes, because the smaller the number of contractors working at clients, the smaller the fees Staff IT would have earned. It did not fire its employees or cut salaries right then because it anticipated a substantial growth in billings from its increased marketing efforts. Had Staff IT generated only half

of the revenue it projected, the Company could have paid its past-due fourth quarter 2001 payroll taxes and made timely deposits of its 2002 payroll taxes. It still had $1.4 million of good receivables, if only it could find a factoring company. Closing Staff IT then would have wasted all these opportunities.

By early 2002, Staff IT's anticipated business increase had failed to materialize and its existing business declined. Staff IT was still looking for financing, and Global Crossing, another Staff IT client, filed for bankruptcy. Again, Mr. McMinn stepped into the gap by loaning the Company $50,000. While Staff IT generated $360,000 of expense cuts during this period, there was still no way Staff IT could have fully paid its payroll tax liability at that time and stay in business.

In February, 2002, Staff IT scaled back some of its debt payments, moved into smaller space, and cut payments to third-party creditors, and by the end of the month, management decided to lay off employees and make even more cost cuts. Even then, Staff IT was not shut down because management believed that when it obtained new financing, the company would turn the corner.

In March, 2002, Staff IT secured a new factor, and laid off some employees and contractors and otherwise cut salaries and costs. Staff IT cut the salaries of each of its three officer-stockholders by 57% retroactive to January 1, and reduced other employees' salaries by 22%. The number of contractors was down, too, reflecting the slump in the Information Technology Sector of the U.S. economy. Even with the new factor, Staff IT could not resume payroll tax deposits until June, 2002. The prior bankrupt factor still retained its lien on Staff IT's receivables, and demanded a $200,000 payment as a condition to releasing the lien. The new factor refused to advance money to Staff IT without first obtaining a lien on Staff IT's receivables as collateral. Staff IT therefore paid over $200,000 to its prior factor to release its receivables so they could be collateralized under the new financing agreement. Here again, had Staff IT paid the IRS instead, the old factor would not have released the receivables. Without financing, Staff IT could not survive.

During the last six months of 2002, however, business started to improve. Staff IT paid most of its payroll taxes as they accrued, but could not pay the back taxes it owed. Staff IT met its wage, interest, and operating cost obligations, but by the end of the year, it owed its attorneys and others more than $200,000.

In mid-October 2003, the IRS sent Staff IT a notice of intent to levy, and later, a notice of tax lien on the Company's assets to collect payroll taxes, interest, and penalties for the three tax quarters ending December 31, 2001, March 31, 2002, and September 30, 2002. The Service asserted late filing and late payment penalties for the fourth quarter of 2001 and the first quarter of 2002, and late deposit penalties for all three quarters at issue. Staff IT requested a Collection Due Process Hearing (hereinafter "CDP Hearing") and sought abatement of the penalties for the quarters ending December 31, 2001 and March 31, 2002 on the ground that the Company had reasonable cause for late filings, late deposits, and late payments. Staff IT requested abatement of the penalties for the quarter ending September 30, 2002 on the ground that the Company had timely filed returns and deposited and paid the taxes when due for that quarter.

At its CDP Hearing in February, 2004, Staff IT presented its request to abate the penalties before an IRS Appeals Officer. Following an adverse determination by the Appeals Officer, Staff IT filed suit in June, 2004 in the Federal District Court for the Southern District of Texas, pursuant to 28 U.S.C. § 1340 and 26 U.S.C. § 6330(d). In December, 2005 the government filed a motion for summary judgment, which the court granted on February 9, 2006 along with its final judgment in this case. Staff IT timely appealed to the United States Fifth Circuit Court of Appeals that portion of the District Court's decision sustaining the IRS' denial of Staff IT's request to abate failure to file, pay and deposit penalties. On March 22, 2007, the United States Fifth Circuit Court of Appeals entered and filed judgment affirming the summary judgment of the district court in favor of the United States. The Fifth Circuit held that Staff IT was

entitled neither to abatement of its penalties for failure to file, nor was it entitled to abatement of its failure to pay or failure to deposit penalties. Having concluded that Staff IT's failure to meet its payroll tax obligations was without reasonable cause, the court decided that it need not determine whether such failure resulted from willful neglect.[24]

REASONS FOR GRANTING THE PETITION

I. A CLEAR CIRCUIT SPLIT EXISTS IN THE LAW.

This case presents a pure question of federal taxation law. The Circuit Courts are split on the issue of whether financial hardship is a ground for abating penalties for late filing, late payment and late deposits of employment taxes. The Fifth Circuit "acknowledge[s] the existence of the circuit split on this issue" and the District Court concedes "[t]his disagreement among the circuits."[25]

As we begin this discussion, it is important to emphasize that this case and the law under consideration involve only one of the possible grounds of "reasonable cause," that ground of financial hardship. Courts have abated payroll tax penalties under other, different "reasonable cause" grounds, but those separate grounds for payroll tax penalty abatement are not at issue here.[26]

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24. *Staff IT*, Pet. App. 20a, n.34.

25. Pet. App. 18a (5th Circuit); *Staff IT, Inc. v. United States*, 2006 WL 314440 at 6 (S.D. Tex. 2006), Pet. App. 37a.

26. The Fifth Circuit in this case momentarily confuses this financial hardship ground with other "reasonable cause" grounds when it states "to our knowledge, only one appellate opinion has ever concluded that a taxpayer's failure to pay payroll taxes in a timely fashion was the result of reasonable cause and not willful neglect." Pet. App. 18a. That statement is true only in the context of financial hardship cases. Other circuits have abated penalties under other, different "reasonable cause" grounds, *e.g.*, *In re American Biomaterials Corp.*, 954 F.2d 919, 927 (3d Cir. 1992) (reasonable cause for penalty abatement existed where a corporation's top management embezzled its funds, thereby incapacitating it and rendering it incapable of making timely payroll tax deposits).

In the Sixth Circuit, financial hardship is *never* a ground for abatement of payroll tax penalties, under its 1994 *Brewery, Inc.* decision.[27] The Sixth Circuit interprets one of the IRS regulations discussed above[28] to impose a higher standard with respect to employment taxes, especially trust fund taxes, and concludes that as a matter of law, financial hardship is never a ground for abatement of employment tax penalties.[29] The policy rationale for this view is that an employer holds payroll taxes in trust for the federal government, and they are for the government's exclusive use. Were an employer to be excused from timely payment and deposits of these taxes held in trust merely on account of its own financial difficulties, the result would be to permit a taxpayer "to self-execute a government loan" or "make the government 'an unwilling partner in a floundering business.'"[30]

By contrast, the Second, Third, Seventh and Ninth Circuits (as well as the Court of Federal Claims) hold that financial hardship *can* be a ground for the abatement or removal of employment tax penalties for late payment and late deposits. They apply a facts and circumstances test based on the IRS regulations discussed above. This is the majority rule.[31] All four

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27. *Brewery, Inc.*, 33 F.3d at 592-593.

28. 26 C.F.R. § 301.6651-1(c)(2), Pet. App. 55a-56a.

29. *Brewery, Inc.*, 33 F.3d at 592-594.

30. *Brewery, Inc.*, 33 F.3d at 593, quoted in *Staff IT*, 482 F.3d at 800, Pet. App. 17a.

31. *Fran Corp.*, 164 F.3d at 818; *East Wind*, 196 F.3d at 507-508; *Diamond Plating Co. v. United States*, 390 F.3d 1035, 1038 (7th Cir. 2004); *Van Camp & Bennion v. United States*, 251 F.3d 862, 867-868 (9th Cir. 2001); *Q.E.D. v. United States*, 55 Fed.Cl. 140 (Fed.Cls. 2003). A recent decision in a district court in the First Circuit has adopted this test, referring to it as the "majority rule," although the First Circuit itself has not ruled on this issue to date. *Francis P. Harvey & Sons, Inc. v. Internal Revenue Service*, 2004 WL 2915309, at 12 (D.Mass. 2004). Similarly, a bankruptcy court in the Eleventh Circuit has adopted this test, although the Eleventh Circuit has yet to rule, *In re The Hilliard Development Corp.*, 2007 WL 1201462 (Bkrtcy.S.D.Fla. 2007). Prior (Cont'd)

circuits, along with the Court of Federal Claims, categorically reject the Sixth Circuit's decision in *Brewery* that financial hardship is never a ground for penalty relief. They do so, based upon an extensive discussion of the tax statutes, regulations, legislative history and public policy.

First, these circuits reject *Brewery* because neither the tax statute nor the regulations discussed above differentiate between trust fund taxes and other taxes which are not kept in trust for the IRS. There is no higher standard for the payment of trust fund taxes than the payment of other taxes when it comes to the penalties for non-payment.[32] Since enactment in 1916, Congress has retained the same "reasonable cause/willful neglect" standard in the tax statutes for all taxes. The *Brewery* decision ignores over 90 years of statutory history.[33]

Second, the IRS regulations instructing courts to evaluate "all the facts and circumstances of the taxpayer's financial situation"[34] and to decide whether the payment of the taxes would result in "undue hardship"[35] or "substantial financial loss"[36] have not been amended for decades, as previously discussed. Regulations "long continued without substantial

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(Cont'd)

to these decisions, some lower courts had also found "reasonable cause" based on financial hardship, including *In re Slater Corp.*, 190 B.R. 695, 700-701 (Bkrtcy.S.D.Fla. 1995) (construction contractor made partial payments on employment taxes and business expenses); *In re Arthur's Indus. Maintenance, Inc.*, 1992 WL 132563 at 6-8 (W.D.Va. 1992) (construction contractor in bankruptcy made no unreasonable expenditures and made significant partial payments of its employment taxes); *In re Pool & Varga, Inc.*, 60 B.R. 722, 725-728 (Bkrtcy.E.D.Mich. 1986) (debtor decreased salary of principal and paid only expenses necessary to avoid closure); *Glenwal-Schmidt v. United States*, 1978 WL 4527 at 3 (D.D.C. 1978) (construction contractor paid only those vendors necessary to complete critical project).

32. *Fran Corp.* 164 F.3d at 818.

33. *Fran Corp.* 164 F.3d at 818.

34. 26 C.F.R § 301.6651-1, Pet. App. 53a-56a.

35. 26 C.F.R § 301.6651-1, Pet. App. 53a-56a.

36. 26 C.F.R § 301.6161-1(b), Pet. App. 58a.

change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law."[37]

A third reason is that the regulation cited as support in *Brewery* for its decision does not actually call for a bright-line test. Instead, it merely requires that courts consider "the nature of the tax that the taxpayer has failed to pay" as one factor in the course of evaluating the taxpayer's care and prudence.[38]

Fourth and most fundamentally, *Brewery's per se* test itself is inconsistent with the policy behind Congress' statutory "reasonable cause" exception and the facts and circumstances test contained in the regulations. To apply *Brewery* "would effectively read out of the statute the 'reasonable cause' exception to mandatory penalties in many employment tax cases"[39] and would "ignore the intent of Congress and the Treasury Department and depart from the established practice of case-by-case assessment of reasonable cause and willful neglect."[40] Congress' purpose for the penalty was to deter willful conduct considered undesirable, not conduct caused by extreme financial difficulties that were not the taxpayer's fault.[41]

Thus, these four circuits endorse the Treasury regulations' facts and circumstances test and utterly reject the *Brewery* decision. Even so, the IRS continues to ignore its own regulations and argue instead for *Brewery*, both in this case[42] and others.[43]

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37. *Cottage Savings Ass'n v. Commisioner*, 499 U.S. 554, 561, 111 S.Ct. 1503 (1991), quoted in *Fran Corp.* 164 F.3d 818.

38. 26 C.F.R. § 301.6651-1(c)(2), Pet. App. 55a-56a discussed in *Fran Corp.* at 164 F.3d at 819.

39. *Fran Corp.* at 164 F.3d at 819; *Van Camp & Bennion*, 251 F.3d at 868.

40. *Fran Corp.* at 164 F.3d at 819.

41. *Fran Corp.* 998 F. Supp. 296, 299 n.4 (S.D.N.Y. 1998), *aff'd*, *Fran Corp.*, 164 F.3d 814.

42. *Staff IT*, Pet. App. 17a (5th Cir.); *Staff IT*, Pet. App. 35a (S.D. Tex.).

43. *Fran Corp.* 164 F.3d at 817; *East Wind*, 196 F.3d at 508.

In applying the facts and circumstances test in the financial hardship context, the four circuits in five cases (two from the Ninth Circuit) have directly or indirectly taken a number of factual elements into account. These include whether a serious financial hardship existed involving a clear choice of paying payroll taxes timely or going out of business;[44] the proximity between the time the hardship occurred and the time the payroll tax payments ceased;[45] how long the payroll taxes were not paid;[46] whether and how the problem that allegedly created the non-payment of payroll taxes was solved;[47] the efforts taken to marshal personal assets and prioritize creditors to stay in

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44. *East Wind*, 196 F.3d at 501-502 (serious financial hardship resulting from Defense Department corruption); *Fran Corp.*, 164 F.3d at 815 (hardship when New York State stopped paying on construction contracts); *Diamond Plating*, 390 F.3d at 1038 (loss of major customer); *Van Camp & Bennion*, 251 F.3d at 866-867 (illness of personal injury attorney in a small law professional corporation strained corporation's finances) ; *Synergy Staffing, Inc. v. United States*, 323 F.3d 1157, 1160 (9th Cir. 2003) (staff leasing company lost some of its line of credit).

45. *East Wind*, 196 F.3d at 502-503 (hardship and failure to pay payroll taxes took place at the same time); *Fran Corp.*, 164 F.3d at 815 (hardship was one year before failure to pay payroll taxes began); *Diamond Plating*, 390 F.3d at 1038 (hardship occurred 3 years before company first missed payroll taxes, held too great an interval).

46. *East Wind*, 196 F.3d at 502 (six consecutive years — 24 calendar quarters); *Fran Corp.*, 164 F.3d at 815 (five consecutive calendar quarters); *Diamond Plating*, 390 F.3d at 1038 (two years — 8 quarters); *Van Camp & Bennion*, 251 F.3d at 865 (two separate years, 8 quarters); *Synergy Staffing*, 323 F.3d at 1158 (ten years in a row; IRS misapplied deposits contrary to taxpayer's instructions, thereby creating a "rolling delinquency" where taxpayer never was current).

47. *East Wind*, 196 F.3d at 502-503 (company filed bankruptcy, and eventually won over $2 million from the Defense Department in a lawsuit in bankruptcy court; proceeds used to pay IRS); *Fran Corp.*, 164 F.3d at 815 (state eventually acknowledged it owed the money, and firm obtain a loan to pay the IRS based on that representation); *Diamond Plating*, 390 F.3d at 1038-1039 (lost customer regained; company president repaid the IRS); *Synergy Staffing*, 323 F.3d at 1161 (remand to district court to determine whether IRS misapplied payments in some quarters).

business;[48] whether and to what extent the firm or its owners/ management unfairly enriched themselves at the expense of the IRS;[49] the nature of the evidence (or lack thereof) presented to the court;[50] and the presence of "red flag-type" frivolous and extravagant expenses.[51]

Absent from these cases is any factor requiring the firing or termination of personnel. No circuit court (at least until the Fifth Circuit) viewed the *absence* of substantial layoffs as evidence of the *absence* of reasonable cause.[52]

The split between the 2nd, 3rd, 7th and 9th Circuits' facts and circumstances test and the 6th Circuit's *Brewery per se* test is the setting within which this case's opinion from the 5th Circuit appears.

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48. *East Wind*, 196 F.3d at 510-511 (owner put in personal funds and mortgaged home to keep company afloat; laid off staff after company stopped getting new contracts; landlord and suppliers not paid); *Fran Corp.*, 164 F.3d at 820 (no evidence that company put its payroll tax obligations ahead of any creditors who were unrelated to the projects that defaulted); *Diamond Plating*, 390 F.3d at 1039 (same).

49. *East Wind*, 196 F.3d at 510-511 (no evidence of unfair personal or corporate enrichment); *Fran Corp.*, 164 F.3d at 819-820 (firm paid office rent to its landlord who was also its president even though he owed the company about $150,000; firm paid auto leasing and car expenses, golf outings and dinner dances that did not relate to the defaulted contracts); *Diamond Plating*, 390 F.3d at 1039 (corporate officers received raises totaling 70% during the time the company owed payroll taxes).

50. *Synergy Staffing*, 323 F.3d at 1160 (company failed to present evidence of what funds it did have on hand each time payroll taxes were due, and produced no evidence on how it spent the money in lieu of paying the taxes).

51. *Fran Corp.*, 164 F.3d at 819-820 (company paid costs of repairing a Porsche automobile while it owed the IRS); *Diamond Plating*, 390 F.3d 1036, 1039 (company president paid off the IRS liability when he first learned about it from the company treasurer, suggesting "an available source of credit tine times of financial difficulty").

52. In one case, employees were laid off because the company was not getting any new contracts, however, this was viewed in the taxpayer's favor. *East Wind*, 196 F.3d 503, 509.

II. THIS CASE PROVIDES AN APPROPRIATE VEHICLE FOR RESOLVING THE CLEAR CIRCUIT SPLIT IN THE LAW.

In its *Staff IT* opinion, the Fifth Circuit takes two contradictory positions. As we will see, the court first purports to apply the majority rule facts and circumstances test, but then does so by distilling it into a two-factor formula to craft a new subset of factors. Next, the court reduces the two-factor formula to one-factor formula. In the process, the court contradicts itself and produces an end result indistinguishable from that of the Sixth Circuit in *Brewery*. The Fifth Circuit's new test is wrong as a matter of law for a number of reasons. In addition to reversing the Fifth Circuit and remanding this case, immediate Supreme Court intervention is needed to keep whatever confusion that the Fifth Circuit's opinion will inevitably produce from spreading to the other circuits yet to rule on the criteria for payroll tax penalty abatement in financial hardship cases.

Neither the Fifth Circuit's convoluted analysis nor the murky result that follows in its wake are readily apparent from a quick, initial reading of the *Staff IT* opinion. Indeed, following the District Court's lead, the Fifth Circuit claims to refuse to choose between the majority facts and circumstances rule and the minority *per se* or "bright-line" rule, on the ground that Staff IT fails both tests.[53] The court then ostensibly applies the "multi-factor" test (i.e., the facts and circumstances test) to Staff IT's facts.[54]

The confusion begins to emerge when the Fifth Circuit condenses all the factors that other circuits have examined to only two factors:

"(1) [T]he taxpayer's favoring of other creditors over the

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53. *Staff IT*, Pet. App. 21a (5th Cir.); *Staff IT*, Pet. App. 38a (S.D. Tex.). The court made no determination whether the element of willful neglect was present or absent. 482 F.3d at 802 n.34, Pet. App. 20a.

54. Pet. App. 15a. Staff IT automatically failed the Sixth Circuit's "bright-line" or *per se* test by the mere fact that it did not pay or deposit its payroll taxes timely, so there was no need to examine Staff IT's facts any further through the lens of this test. *See*, 482 F.3d at 800, Pet. App. 17a.

government, which weighs against a finding of reasonable cause, and

"(2) the taxpayer's willingness to decrease expenses and personnel, which weighs in favor of a finding of reasonable cause."[55]

In creating its two-factor formula, the Fifth Circuit ignores factors that the other circuits applying facts and circumstances have deemed important. Whether the owners put in their own money to help bail out the business, enrichment by the owners at IRS expense, prioritizing creditors, the existence of true choices between going out of business or paying the IRS — none of these factors that other circuits have examined or considered appear in the Fifth Circuit's two factor test.

The Fifth Circuit then injects a new element that exists neither in the regulations nor in the circuit court opinions (but it is present in the District Court opinion); this element is "the taxpayer's willingness to decrease . . . personnel . . .", found in factor (2).[56] Under this element, financially strapped employers in the Fifth Circuit who do not fire enough employees soon enough risk being unable to show reasonable cause for paying payroll taxes late.

In addition, one of the two factors contains a test that no taxpayer can satisfy. This factor is "(1) the taxpayer's favoring of other creditors over the government."[57] A closer look at factor (1) reveals that *every* taxpayer seeking abatement of its penalties due to late deposits or payment must, in one way or another, favor other creditors over the government. Indeed, *each time* an employer pays the rent on time but deposits its payroll taxes late, it can be said to "relegate its obligation to the government to those owed to its other creditors . . ." in the words of the court.[58] Such conduct fails Fifth Circuit factor (1).

What authority does the Fifth Circuit give for this new test? None. In place of citing a single statute, regulation or case, the

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55. 482 F.3d at 801, Pet. App. 19a.

56. Pet. App. 19a (5th Cir.); Pet. App. 42a-43a (S.D. Tex.).

57. Pet. App. 19a.

58. Pet. App. 20a.

court merely asserts that "the jurisprudence reflects" this test.[59] The court's ostensible motive for this test is to avoid "second guessing" Staff IT's business decisions in confronting financial hardship: "We neither penalize [Staff IT] for its unsuccessful efforts to 'grow' its business nor credit its decisions to cut its expenses . . ."[60] However, a closer look at the court's two factors suggests that this reluctance to apply hindsight is more apparent than real: The second factor's focus on the taxpayer's willingness to cut costs and fire employees and the first factor's emphasis on not paying creditors and suppliers so that the IRS can be paid instead necessarily involves the sort of second guessing and hindsight that the court purportedly seeks to avoid.

So far, then, the Fifth Circuit has presented what it calls a multi-factor test, but when we study it, we discover that it contains only two factors. We learn that it omits many of the elements that the other circuits have considered while injecting a new element — employee firings — that is absent from the Treasury Regulations and other circuit court opinions. We also discover that one of the factors is conceived in such a way that every taxpayer late in any payroll tax payment will find it impossible to satisfy.

It gets worse: Buried in a footnote in the final paragraphs is some "fine print" which contradicts what the court has said up to that point in the opinion. In the footnote, the court discloses that its ruling is based only on the first factor of its two-factor test (the one that the taxpayer can never win). The court states: ". . . [O]ur decision is based *solely* on [Staff IT]'s conscious, knowing decision to satisfy essentially all of its obligations ahead of its payroll tax obligations." (Emphasis added.)[61] The court's stated reluctance to second-guess business decisions or to "nitpick" marketing expenses[62] rings hollow in the face of basing its ruling on the one factor in the formula that a taxpayer can never satisfy.

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59. Pet. App. 19a.
60. Pet. App. 19a, n.33.
61. Pet. App. 20a, n.33.
62. Pet. App. 20a, n.33.

Thus, the Fifth Circuit began by ostensibly applying what it called the multi-factor test. It then clouded the picture when it created a new two-factor formula out of whole cloth. Finally, it doubled back and unraveled its own creation by morphing its two-factor formula into a one-factor formula that every taxpayer will fail. The form of the Fifth Circuit's purported facts and circumstances test cloaks its true identity as a *per se* test that the taxpayer will always lose and the IRS will always win.

That happens to be the same end result as the Sixth Circuit's *Brewery's per se* test — there, too, the IRS always wins. Perhaps coincidentally, the Fifth Circuit's criticism of late payroll tax payments as "the self-execution of a government loan" echoes the language of the *Brewery* decision.[63] (However, upon reflection for a moment, isn't *every* late tax payment, no matter how small, a "self-executing government loan?")[64] Does the new Fifth Circuit test constitute a sort of "stealth-*Brewery*" decision? Was claiming not to decide between the Sixth Circuit and the other circuits the Fifth Circuit's way of trying to "cert-proof" itself from the inevitable challenge it would have received by following the Sixth Circuit and *Brewery*?

Such questions should not be permitted to obscure the fact that the Fifth Circuit's decision has now hopelessly muddied the waters in this area of the law, particularly for the other circuits which have yet to wade into what has become tantamount to a quagmire. The Supreme Court should intervene in this case to prevent the law in this area from becoming hopelessly confused.

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63. *Cf. Staff IT*, Pet. App. 20a, with *Brewery, Inc.*, 33 F.3d at 593.

64. The implication is that "self-executing government loans" are rare examples of taxpayers seeking special treatment. However, this is not the case. Applying the *Brewery* definition of a "self-executing government loan" at 33 F.3d at 593, every taxpayer who holds back money due the IRS on April 15th and uses it to pay the electric bill has helped himself or herself to a "self-executing government loan." In Fiscal Year 2005, there were nearly 6 million such "self-executing government loans." *Internal Revenue Service Data Book 2005*, at 34, *available at http://www.irs.gov/pub/irs-soi/05databk.pdf* (last visited August 9, 2007).

III. A UNIFORM NATIONAL STANDARD IS NEEDED.

A close relationship exists between payroll taxes, employee terminations and job loss. The Third Circuit describes the interplay between these competing considerations:[65]

> "Although we recognize the need for stringent standards where trust fund taxes are involved, we cannot ignore the negative impact the Government's position has on public policy. The IRS has consistently taken the position that if a taxpayer cannot afford to pay trust fund taxes, no matter what the cause, it should close up shop. Both the economy and the federal fisc are negatively impacted by such an approach—the amount of money flowing into the economy and the fisc is reduced as a result of increased unemployment, idle buildings and plants, and decreased sales of goods and services. Under this approach, no one benefits."

This tradeoff between payroll tax payments and job loss is built into the Fifth Circuit's two-factor test since, as we have seen, the Fifth Circuit appears to encourage personnel terminations as a means for employers behind in their taxes to show reasonable cause to justify removal of penalties.[66]

The District Court cements the close relationship between tax payments vs. job loss when it criticizes Staff IT for not firing its staff and employees soon enough: "A taxpayer's willingness to cut costs and personnel is also highly relevant. [citation omitted] . . . Yet Staff IT *delayed significant personnel reductions* . . . Staff IT retained its employees and contractors . . . When Staff IT *finally* did make personnel and expense cuts, *it was too late* . . ." (Emphasis added.)[67]

Payroll taxes protect employees by funding their social security and Medicare benefits and by enabling them to pay their income taxes through withholding as they earn their wages. The Fifth Circuit and District Court's suggestion of firing the

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65. *East Wind*, 196 Fd.3d at 509.

66. *Staff IT*, 482 F.3d at 801 (factor no. (2)), Pet. App. 19a.

67. Pet. App. 42a-43a.

very persons whom the payroll tax system was created to protect, as a means to ensure that payroll taxes are paid on time, seems perverse; it has not been adopted by any of the four circuits applying the facts and circumstances test.

The Fifth Circuit opinion creates a morass out of the previously existing circuit split. In the Fifth Circuit, business owners facing hardship situations must fire personnel if they want to show reasonable cause. By contrast, employers in the Second, Third, Seventh and Ninth Circuits know they can take reasonable measures to keep their businesses afloat without incurring ruinous penalties; but in the Sixth Circuit, they know they must take draconian steps by firing personnel and the like to avoid penalties. In the rest of the circuits (the First, Fourth, Eighth, Tenth, Eleventh and Federal Circuits) where the circuits have yet to rule, business owners must guess which of these competing standards applies to them. This is a recipe for mass confusion. The analysis and application of such a basic *federal* tax provision as this one should be uniform across the nation.

However, adoption of the Treasury regulations' facts and circumstances test by this Court does not automatically guarantee such uniformity. The regulations envision situations where penalties should be abated in undue hardship situations,[68] but at least one court applying those regulations limits them to "rare" situations.[69] The Fifth Circuit speaks of the taxpayer's "heavy burden" to show reasonable cause, noting that only in the *East Wind* decision was the taxpayer's position sustained.[70] (*East Wind* involved U.S. Defense Department officials soliciting bribes from a government contractor for it to continue producing uniforms for the military; the financial hardship and the resulting payroll tax delinquency resulted after the corrupt

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68. IRS regulations' facts and circumstances/multi-factor test provides for penalty abatement where "substantial financial loss . . . will result to the taxpayer for making [a tax] payment on the due date." 26 C.F.R. §1.6161-1(b), Pet. App. 58a, discussed above.

69. *Fran Corp.*, 164 F.3d at 819.

70. *Staff IT,* Pet. App. 18a. The District Court takes essentially the same view, Pet. App. 37a.

officials retaliated against the contractor for not paying the bribes.[71])

Such a narrow application of the regulations violates both their letter as well as their spirit. "The regulations clearly anticipate that a taxpayer will be forced to decide during times of financial distress how to distribute any available cash."[72] The regulations' language does not limit penalty relief only to situations where the financial hardship results from government corruption, i.e., where "the Government was not an unwilling partner in a floundering business but an active participant."[73] In fact, courts have abated penalties for late payment in many contexts outside that of financial hardship under the same reasonable cause law and regulations at issue in this case.[74]

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71. *East Wind*, 196 F.3d at 501-503.

72. *East Wind*, 196 F.3d at 508.

73. *East Wind*, 196 F.3d at 509.

74. Late payment penalties for payroll taxes were held as grounds abatement in "reasonable cause" grounds different from financial hardship, *e.g., In re American Biomaterials Corp.*, 954 F.2d at 927 (corporation's chairman and chief executive officer embezzling funds incapacitated the corporation and rendered it incapable of making payments or deposits of payroll taxes); *Van Camp & Bennion*, 251 F.3d at 867-868 (whether reliance on accountant or the serious illness of a primary shareholder is reasonable cause is a question of fact); *Diaz v. United States*, 1990 WL 61960, CCH 90-1 USTC ¶ 50,209 (C.D.Calif. 1990) (traffic violator school operator's good faith belief that his employees were independent contractors). Outside the payroll tax area, other courts have excused late payment penalties for taxes in cases not involving financial hardship, *e.g., Gillis v. Commissioner*, T. C. Memo 1986-576 (1986) (Air Force officer's reliance on an Air Force legal counsel that the officer qualified for the foreign earned income exclusion); *Brown v. United States*, 630 F.Supp. 57 (M.D. Tenn. 1985) (illness of an attorney where the administrator was elderly, infirm and inexperienced); *Harper v. United States*, 1994 WL 792540, CCH 95-1 USTC ¶ 50,139 (E.D. Okla. 1994) (married couple unable to obtain necessary information about their investments by April 15 income tax due date, despite reasonable efforts, and they reasonably relied on the advice of their accountant); *Carnahan v. Commissioner*, 70 F.3d 637 (Cont'd)

Nothing in the IRS' regulations authorizes the courts to set a higher bar for granting relief from penalties in financial hardship situations than for granting relief in other circumstances where there is reasonable cause and not willful neglect. To impose a greater standard in financial hardship situations that is not authorized by the regulations is to repeat the *Brewery* court's mistake of erecting a more onerous standard for trust fund taxes than for other taxes in absence of any statutory and regulatory authorization.

The facts and circumstances test in the IRS' regulations does not require "that courts turn a blind eye to the taxpayer's financial circumstances."[75] Indeed, the regulations authorize neither the Fifth Circuit's sham two-factor formula (where the IRS always wins), nor a restriction to situations involving federal government corruption, nor a requirement to conduct wholesale personnel layoffs. Instead, the regulations' test envisions a "level paying field" applicable to taxpayers and the IRS alike.

The fact patterns in financial hardship cases are many and varied. Without attempting to suggest a "one size fits all"

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(Table), CCH 95-2 USTC ¶ 50,592 (Fed. Cir. 1995), *aff'g* T.C. Memo 1994-163 (an attorney's late payment of income taxes was due to "reasonable cause" where he was hospitalized for mental illness); *In re Dennis Erickson*, 172 B.R. 900 (Bankr. Minn. 1994) (quadriplegic whose tax preparer and bookkeeper did not complete the returns timely so that he could pay taxes on time had reasonable cause for late payment of income taxes); *Ferwerda v. United States*, 1979 WL 1484, CCH 79-2 USTC ¶ 9677 (E.D.Wis. 1979) (husband relying upon an agreement with the IRS to defer collection of taxes until the wife's bankruptcy proceedings were concluded); *Fleming v. Commissioner*, T.C. Memo 1984-130 (1984) (wife whose husband refused to divulge information about his personal and company affairs believing that her husband and his counsel were acting on her behalf to comply with the tax laws); *Estate of La Meres v. Commissioner*, 98 T.C. 294, 324-326 (1992) (late payment estate tax penalties were abated where an executor whose election to defer payment of estate taxes was incorrectly made on a late filed return due to his attorney's erroneous advice).

75. *Fran Corp.*, 164 F.3d at 818.

approach, Petitioner commends to this Court the factors contained in the recent decision of *Francis P. Harvey & Sons*[76] as one set of criteria that appears to produce a balanced and impartial blending of the important elements common in penalty abatement decisions in financial hardship situations. These factors are:

> [T]he taxpayer faced a real choice between making payments to the IRS and going out of business, and (1) the duration of the financial crisis was relatively limited in time; (2) the occurrence of one or more specific contingencies (such as payment of a contractual obligation) was expected to alleviate the crisis; (3) the taxpayer was prioritizing creditors and marshaling personal and other resources in order to avoid going out of business; and (4) the taxpayer was not unfairly enriching itself (or its owners) or unfairly favoring other creditors ahead of the IRS.[77]

Absent from these factors is the Fifth Circuit's (and the District Court's) partial litmus test of employee layoffs as a *sine qua non* for showing reasonable cause. The absence of employee firings should not automatically produce a finding of the absence of reasonable cause. Courts deciding the issue of penalty abatement should not be put into the position of counting the number of employee pink slips that have been issued.

A "level playing field" truly exists where the taxpayer and the IRS play by the same rules, and where the rules themselves guarantee neither a taxpayer nor an IRS victory. While the *Harvey* factors are not the only ones that might be devised, nonetheless, the fact that the *Harvey* court granted the IRS summary judgment[78] after applying them demonstrates that a fair and impartial test will protect the government from being

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76. *Francis P. Harvey & Sons*, 2004 WL 2915309 at 14 (D. Mass. 2004). The court applied its factors in the process of granting summary judgment to the IRS. 2004 WL 2915309 at 15.

77. *Francis P. Harvey & Sons*, 2004 WL 2915309 at 14.

78. *Francis P. Harvey & Sons*, 2004 WL 2915309 at 15.

made "an unwilling partner in a floundering enterprise," and that a fair test will not open the floodgates. What is needed is for this Court to prescribe a test that can be applied to the recurring question of penalty abatement in financial hardship situations, while at the same time conforming to the spirit and letter of the regulations' facts and circumstances/multi-factor standard.

IV. PAYROLL TAX LAWS AFFECT A VAST NUMBER OF BUSINESSES AND EMPLOYEES.

Payroll taxes generate huge amounts of revenue, are collected from millions of taxpayers and can have a significant impact upon small businesses.

Payroll taxes are by far the federal government's largest source of income. In 2005, the IRS collected over $1.5 trillion from FICA and payroll tax withholdings—twice as much money as the IRS collected from all other sources combined. Payroll taxes account for nearly five times as much federal income as the corporation income tax, and nearly 60 times as much as all estate and gift taxes.[79]

Payroll taxes are collected from a broad section of the American public. According to the economic census in 2002, there were 5.6 million employer firms with receipts totaling over $22 trillion, of which nearly $4 trillion (almost 20%) went to payroll for their 112 million paid employees.[80]

The IRS recognizes the importance of payroll taxes. The IRS performs millions of employment tax audits each year. In fiscal year 2005, the Service assessed civil penalties involving 7,681,939 returns. About half of those returns involved late payment penalties, and an additional 28% of those returns involved the late deposit penalty. During the same period, the amount of the civil penalties totaled about $6.6 billion, of which

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79. *Internal Revenue Service Data Book 2005* (Table 1), *available at http://www.irs.gov/pub/irs-soi/05databk.pdf* (last visited August 9, 2007).

80. U.S. Census Bureau, "Statistics About Business Size" (Table 2b), *available at http://www.census.gov/epcd/www/smallbus.html* (last visited August 9, 2007).

the late deposit penalty accounted for over $4.5 billion, or 68% of the total.[81]

The laws governing payroll tax withholding and penalties are particularly important to small businesses. Small businesses are more vulnerable to economic changes than large businesses and have high turnover: In 2004, an estimated 580,900 employer firms opened, while an estimated 576,200 closed—and 2004 was a growth year for the United States economy.[82] According to the Small Business Administration of the United States Department of Commerce, about one-third of new small business establishments close within two years after start-up, and 56% close within four years. Small businesses also pay about 45% more per employee to comply with federal regulations than large businesses do.[83]

Despite these vulnerabilities, small businesses comprise a vital part of the U.S. economy and the job market. In 2005, small businesses represented 99.7% of the total number of employer businesses while providing slightly more than half of all the non-farm private sector jobs.[84] In addition, the smallest businesses (those with fewer than 20 employees) accounted for roughly three-fourths of the number of all employer businesses in 2004.[85] Recent job statistics collected by the federal government reveal that 65% of

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81. *Internal Revenue Service Data Book 2005* (Table 27), *available at http://www.irs.gov/pub/7irs-soi/05databk.pdf* (last visited August 9, 2007).

82. U.S. Department of Labor, "Employment Status of the Civilian Noninstitutional Population, 1940 to Date," *Labor Force Statistics from the Current Population Survey, available at http://www.bls.gov/cps/cpsaat1.pdf* (last visited August 9, 2007).

83. John McDowell, "Small Business Continues to Drive U.S. Economy" (SBA Press Release October 3, 2005), *available at http://www.sba.gov/advo/press/05-46.html* (last visited August 9, 2007).

84. John McDowell, "Small Business Drives the U.S. Economy" (SBA Press Release September 28, 2006), *available at http://www.sba.gov/advo/press/06-17.html* (last visited August 9, 2007).

85. U.S. Census Bureau, "Statistics About Business Size" (Table 2a), *available at http://www.census.gov/epcd/www/smallbus.html* (last visited August 9, 2007).

America's net *new* jobs are provided by small businesses. Small businesses comprise 97% of America's exporters and produce over one-fourth of all export value.[86]

Small business has recently become the engine for job growth in the US economy. The following table shows just how heavily the U.S. economy has relied on small businesses for new jobs. In the five year period 1997-2002, small business accounted for only 25% of new jobs; in the two most recent years for U.S. Census Bureau business size statistics (2002-2004), small business employment grew much more rapidly, and was responsible for 83% of the new jobs.[87]

	Small Business Jobs	*Large Business Jobs*	*Total*
1997-2002 (5 years)	1,800,000	5,200,000	7,000,000
2002-2004 (2 years)	2,200,000	443,000	2,643,000

It is axiomatic that growth cannot last forever. Recently, the chairman of the Congressional Joint Economic Committee raised serious concerns about the sustainability of the current level of growth, noting the "anemic U.S. economic growth of 1.3 percent this quarter is not surprising given the weak housing market and an increasing trade deficit", which he characterized as "body blows to the U.S. economy".[88] Whether or not the

86. John McDowell, "Ten Reasons to Love Small Business" (SBA Press Release February 9, 2006), *available at http://www.sba.gov/advo/press/06-04.html* (last visited August 9, 2007).

87. U.S. Small Business Administration, *Statistics of U.S. Business*, *available at http://www.sba.gov/advo/research/us88_04.pdf* (last visited August 9, 2007). From 1997 to 2002 employment increased by 1.8 million for small businesses and 5.2 mill for large businesses; from 2002-2004 the increase was 2.2 million for small businesses and 443,000 for large businesses.

88. Senator Charles E. Schumer, "Joint Economic Committee Chair Calls Weak Housing Market and High Trade Deficits 'Body Blows to the U.S. Economy'," (April 27, 2007), *available at http://www.jec.senate.gov/Documents/Releases/04.27.07gdpreact.pdf* (last visited August 9, 2007).

economy's growth is "anemic," the fact remains that any slowdown will mean more businesses will be faced with the choice of being late on their payroll taxes or firing employees to ensure they have enough cash to remain current.

Conditions for small businesses are of particular importance to the growing numbers of women and minority entrepreneurs. From 1979 to 2003, the rate of self-employment for African-Americans grew at nearly four times the white rate; the rate of self-employment for women increased at thirteen times the male rate.[89] In 2006, members of ethnic minorities owned 4.1 million firms that generated $694 billion in revenues and employed 4.8 million workers; women owned 6.5 million businesses that generated $950.6 billion in revenues, and employed 7.2 million workers. Virtually all of these were small businesses.[90] A recent government study on inner city economies revealed that small businesses employ about nine million inner city workers, comprise more than 99% of inner city business establishments, and generate 80% of the total employment in the inner city.[91]

These impressive job gains (mostly in small business) are worth protecting. By ending the current split in circuits and affirming the Treasury regulations' facts and circumstances test, this Court will aid in that important objective.

CONCLUSION

For the reasons stated above, the Petition for a writ of certiorari should be granted.

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89. John McDowell, "Self-Employment Up Sharply for Women, Blacks, and Latinos" (SBA Press Release December 2, 2004), *available at http://www.sba.gov/advo/press/04-38.html* (last visited August 9, 2007).

90. John McDowell, "Small Business Continues to Drive U.S. Economy" (SBA Press Release October 3, 2005), *available at http://www.sba.gov/advo/press/05-46.html* (last visited August 9, 2007).

91. John McDowell, "Small Business Drives Inner City Growth and Jobs" (SBA Press Release October 11, 2005), *available at http://www.sba.gov/advo/press/05-32.html* (last visited August 9, 2007).

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT DATED MARCH 22, 2007

UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 06-20292

STAFF IT, INC., a Texas Corporation,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

March 22, 2007

Before GARWOOD, WIENER, and CLEMENT, *Circuit Judges*.

WIENER, *Circuit Judge*:

Plaintiff-Appellant Staff IT, Inc. ("S.I.") failed to file, pay, and deposit payroll taxes during the course of three tax quarters. The Internal Revenue Service ("IRS") initiated collection proceedings against S.I., seeking the unpaid taxes, interest on them, and penalties for S.I.'s failure timely to file, pay, and deposit such taxes. After the IRS Office of Appeals administratively sustained a proposed levy, S.I. filed a complaint in the district court, contending that, because of financial hardship, it should be excused from paying the

penalties. The district court ruled against S.I., which then appealed to us.

On appeal, the government relies on *Brewery, Inc. v. United States*[1] in arguing that financial hardship can never be a justification for the abatement of employment tax penalties. In diametric opposition, S.I. relies on caselaw from the Second,[2] Third,[3] Seventh,[4] and Ninth Circuits[5] in arguing that financial hardship may justify the abatement of employment tax penalties, insisting that it does so under the facts and circumstances present here.

Like the district court, we need not decide today whether financial hardship may ever justify the abatement of employment tax penalties. Instead, we hold that S.I. is not entitled to an abatement of penalties even when we assume *arguendo* that, under some circumstances, penalties for failure to file, pay, and deposit payroll taxes could be abated for financial hardship.

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1. 33 F.3d 589 (6th Cir.1994).

2. *Fran Corp. v. United States*, 164 F.3d 814 (2d Cir.1999).

3. *E. Wind Indus., Inc. v. United States*, 196 F.3d 499 (3d Cir.1999).

4. *Diamond Plating Co. v. United States*, 390 F.3d 1035 (7th Cir.2004).

5. *Van Camp & Bennion v. United States*, 251 F.3d 862 (9th Cir.2001).

Appendix A

I. *FACTS AND PROCEEDINGS*

S.I. is an accrual-basis taxpayer operating out of Houston, Texas. It was incorporated in 1996 as a personnel staffing company specializing in providing computer programmers and other technical personnel ("contractors") to outside businesses ("clients"). Typically, clients would engage S.I. to fill vacancies in their computer programmer or other technical positions.

Contractors hired by S.I. would be placed on S.I.'s payroll, but would work under the designated client's direction. Each pay period, S.I. would pay the contractors their net compensation after withholding such items as income and social security taxes. S.I. would invoice the client for the contractors' services, including a surcharge for S.I. Clients would usually pay S.I. within thirty to ninety days after being invoiced.

Based on its invoicing practice, S.I. had to carry its costs between the time it paid its contractors and the time it received payment from its clients. This practice required substantial working capital to cover the resulting time gap. Some of this required capital came from S.I.'s officer-stockholders who invested in or made loans to S.I., but S.I. still had to borrow a significant portion of its working capital from financial institutions.

As a relatively small business with no "hard" assets, such as land, buildings, equipment, or manufacturing facilities, S.I. was not able to borrow capital from traditional banks. Other than a few computers, desks, and chairs, S.I.'s only

assets were its accounts receivable, which mainline banks ordinarily deem to be insufficient collateral. Thus, S.I.'s only source of working capital was financing companies ("factors" or "factoring companies").

In the factoring process, a business sells its accounts receivables to a finance company at a discount. Then, as the business collects its receivables, it repays the factor. (In some cases, clients pay the factor directly.)

In 2001, S.I. obtained financing through Prinvest Capital Corp. ("Prinvest"), a factoring company. Under the factoring agreement, Prinvest would advance S.I. approximately seventy to eighty percent of the revenue expected from a S.I. client, and S.I. would instruct the client to pay Prinvest directly. Then, when Prinvest received payment from the client, Prinvest would deduct its charges and forward the remainder to S.I. By mid-2001, S.I.'s annual billings had grown to approximately $16,000,000.00, and Prinvest was financing approximately one-third of S.I.'s receivables.

S.I. employed more than two hundred contractors, had accrued monthly revenues of almost $1,600,000.00, and had a monthly cash flow of over $2,000,000.00. S.I.'s payroll taxes were almost $3,000,000.00 in 2000 and almost $2,000,000.00 from January to September 2001. Until the last tax quarter of 2001, S.I. timely filed, paid, and deposited its payroll taxes.

Beginning in May 2001, S.I. began to experience a series of financial set backs. During the months of May, June, and July 2001, S.I.'s largest client, Compaq Computer, laid off a

significant portion of its workforce, including 55 of its 106 S.I. contractors. As a result, S.I. lost $400,000.00 in revenue. During the same period, Enron and Dynegy, smaller S.I. clients, laid off 12 S.I. contractors.

In June 2001, as a response to the Compaq lay-offs, Prinvest refused to finance any more of S.I.'s receivables, eventually declaring bankruptcy in August of that year. This left S.I. with no financing source. S.I. began negotiations with another potential lender to replace Prinvest and obtained an informal financing agreement in September. This eventually fell through, however, during the period of financial uncertainty that followed the September 11, 2001 terrorist attacks.

In October 2001, Prinvest demanded a substantial loan repayment from S.I., threatening to contact S.I.'s clients directly and call in all S.I.'s receivables if the repayment were not made. Rick McMinn, a S.I. officer and 40% stockholder, together with S.I.'s other two officer-stockholders, personally guaranteed Prinvest's loan to S.I. McMinn used his home as collateral in borrowing $300,000.00, which he then loaned to S.I. on the same terms that the bank had loaned that money to him. S.I. used those funds to pay the $300,000.00 to Prinvest.

S.I. cut some minor expenses during this period. Some of these expenses were not eliminated, however, but were merely deferred until the following month.

S.I. continued to place contractors at Enron and Compaq in October 2001, despite announcements that these two

clients would indefinitely suspend invoice payments. S.I. cut other "G&A" costs—a catch-all category of expenses—including some advertising and recruiting expenses, but did not issue a broad directive to cut expenses. S.I. paid $100,000.00 to creditors other than Prinvest in October while increasing its marketing efforts by shifting two staff employees from the recruiting of contractors to the selling of S.I.'s services (i.e., marketing). The marketing efforts were part of S.I.'s plan to overcome its financial difficulties by "growing" the business and catching-up.

Enron continued to weaken in November and December of 2001, eventually filing for bankruptcy protection. S.I. lost approximately $450,000.00 in receivables as a result, but did not file a claim in the bankruptcy proceeding because of the attendant expenses and fees and the likelihood of an unfavorable result.

S.I. failed to make payroll tax deposits in November and December 2001. During these months, S.I. delayed payments to some third-party creditors and on some debts, but did not reduce (1) the number of contractors on its payroll, (2) the number of its employees, or (3) salaries (not even the salaries of its three officer-stockholders at $240,000 per annum each). Neither did S.I. issue a broad directive to reduce expenses. At that time, S.I. was anticipating a growth in business from its increased marketing efforts, which S.I. hoped would enable it to pay its past-due fourth quarter 2001 payroll taxes, as well as to make timely deposits of its 2002 payroll taxes.

S.I. continued to spend on marketing, advertising, and operating expenses. It also continued to provide monthly

vehicle allowances for those of its employees who had to drive to clients' places of business, and to take clients to Houston Astros games, including paying for season parking. During the time in question, S.I. spent $3,500.00 on a Christmas party, expended additional funds for promotional items, such as drink koozies and rulers, and paid $800.00 for Christmas hams for its contractors. S.I. also continued to entertain clients by treating them to meals. S.I. justified these expenses as part of its advertising and client-relations efforts.

By early 2002, S.I.'s anticipated business increase had failed to materialize and its existing business declined. S.I. had still not obtained a new factor to replace Prinvest, and Global Crossing, another S.I. client, filed for bankruptcy. S.I. did attempt to cut some costs, but negative cash flow outpaced these savings.

In February 2002, S.I. scaled back some of its debt payments, reduced rent payments, and cut payments to third-party creditors; yet it continued to pay its employees and contractors, and its operating expenses in full. S.I. made no layoffs and did not reduce salaries. In the absence of a factor, McMinn loaned S.I. another $50,000.00. S.I. did not make any payroll tax deposits in January or February of 2002, continuing to believe that the downturn was temporary and to hope that once it secured a new factor, it would be able to pay the IRS.

Early in 2002, S.I. finally secured a new factor. Now accepting the need to reduce expenses, S.I. laid off some employees and contractors and otherwise cut salaries and costs. S.I. reduced the salaries of its three officer-stockholders

by 57% from 2001 levels—down from $240,000.00 to $104,000.00. S.I. reduced other employees' salaries by 22% from 2001 levels and cut the monthly vehicle allowances and client meals that it had funded. S.I. also reduced advertising by 18% from 2001 levels.

S.I.'s newly secured factor would not advance funds without first obtaining a lien on S.I.'s receivables. As Prinvest still maintained a lien on S.I.'s receivables, S.I. paid Prinvest more than $200,000.00 to release its lien on S.I.'s receivables. Although S.I. continued to pay its operating expenses, it made no payroll tax deposits in March, April, or May of 2002. It did not start to make significant payroll tax deposits until June.

Even then, S.I. did not pay its back payroll taxes to the IRS. During the last six months of 2002, however, S.I. paid most of its payroll taxes as they accrued, with the exception of December. In that month, S.I.'s new factor retained invoiced payments, causing S.I. to fall short on its deposit of payroll taxes. S.I. met its wage, interest, and operating cost obligations, but by the end of the year, it owed its attorneys and others more than $200,000.00.

In mid-October 2003, the IRS sent S.I. a notice of intent to levy on the company's assets to collect payroll taxes, interest, and penalties for the three tax quarters ending December 31, 2001, March 31, 2002, and September 30, 2002. The penalties at issue were: (1) late-filing penalties for the fourth quarter of 2001 and the first quarter of 2002, pursuant to 26 U.S.C. § 6651(a)(1); (2) late-payment penalties for the fourth quarter of 2001 and the first quarter

of 2002, pursuant to 26 U.S.C. § 6651(a)(2); and (3) late-deposit penalties for all three quarters at issue, pursuant to 26 U.S.C. § 6656.

On November 7, 2003, the IRS sent S.I. a Notice of Federal Tax Lien Filing in connection with the company's unpaid payroll taxes (excluding penalties and interest) for the same quarters. In these notices, the IRS advised S.I. of its right to seek a Collection Due-Process ("CDP") hearing under 26 U.S.C. §§ 6320 and 6330.

S.I. requested a CDP hearing with respect to both the proposed levy and the notice of tax lien, challenging the penalties against it but not the underlying tax liabilities or interest. It requested abatement of the penalties for the quarters ending December 31, 2001 and March 31, 2002 on the ground that the company had reasonable cause for late filings, late deposits, and late payments. S.I. requested abatement of the penalties for the quarter ending September 30, 2002 on the ground that the company had timely filed returns and deposited and paid the taxes when due for that quarter.

S.I. met with an IRS Appeals Officer on February 17, 2004, regarding its request for abatement of penalties. The Appeals Officer issued a notice of determination denying S.I.'s requests for penalty abatement and an installment plan, but gave S.I. until May 10, 2004, to satisfy its current compliance requirements. The Appeals Officer concluded that S.I. had not shown reasonable cause for failing to file timely returns or to make timely deposits and payments. He observed that, even though S.I. obviously faced financial

difficulties during the period at issue, the company had continued to furnish contractors to clients despite learning that the clients would not be making timely payments. The Appeals Officer also noted that S.I. had continued to pay its corporate officers, who were not essential creditors.

In June 2004, S.I. filed suit in the district court, seeking review of the notice of determination. There, S.I. asserted that its financial hardship in 2001 and 2002 constituted reasonable cause for its failure timely to file, to pay, and to deposit payroll taxes. In December, the government filed a motion for summary judgment, asserting, *inter alia*, that *financial hardship* can never constitute *reasonable cause* for the abatement of payroll tax penalties.

In its written ruling, the district court acknowledged the existence of a split in authority on the standards governing financial difficulty/reasonable cause cases. The court observed that (1) the Sixth Circuit had held that financial difficulties can never constitute reasonable cause to excuse penalties for a taxpayer's failure to satisfy its payroll tax obligations; but (2) several other courts of appeals had rejected the Sixth Circuit's bright-line rule and had held that all facts and circumstances of the taxpayer's financial situations must be assessed to determine whether the taxpayer has demonstrated reasonable cause that would entitle it to an abatement.

Rather than decide which standard to apply, the district court concluded that under either standard, the government was entitled to summary judgment because S.I. had not shown

that its failure to satisfy its payroll tax obligations resulted from reasonable cause. S.I. timely filed a notice of appeal.

II. *LAW AND ANALYSIS*

A. Standard of Review

We review grants of summary judgment *de novo*, applying the same standard as the district court.[6] Summary judgment is appropriate when there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law.[7] In collection due process cases in which the underlying tax liabilities are at issue, we review the underlying tax liability *de novo* and other administrative decisions for an abuse of discretion.[8] Determination of the presence of the elements required to prove reasonable cause for failure to satisfy payroll tax obligations is a question of law, but determination whether those elements are present in a given situation is a question of fact.[9]

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6. *Abarca v. Metro. Transit Auth.*, 404 F.3d 938, 940 (5th Cir.2005).

7. *Dallas Fire Fighters Ass'n v. City of Dallas*, 150 F.3d 438, 440 (5th Cir.1998).

8. *Jones v. Commissioner*, 338 F.3d 463, 466 (5th Cir.2003).

9. *United States v. Boyle*, 469 U.S. 241, 249 n. 8, 105 S.Ct. 687, 83 L.Ed.2d 622 (1985).

Appendix A

B. Merits

The Internal Revenue Code ("IRC") requires employers to deduct and withhold income and social security taxes from its employees' salaries and wages.[10] These taxes must be held by the employer in a special trust fund for the benefit of the government.[11] An employer is liable for the payment of the taxes required to be withheld and is required to report the amounts of withheld taxes on its payroll tax returns.[12] These returns and payments of payroll taxes are due each calendar quarter.[13] An employer is required to deposit the employment and income taxes withheld in an approved bank at various intervals during a calendar quarter, depending on how much is withheld.[14]

The IRS imposes mandatory penalties for failure to (1) file payroll tax returns, (2) pay payroll taxes, and (3) deposit payroll taxes in a government-authorized depository, unless the taxpayer can demonstrate that such failure was occasioned by "reasonable cause and not due to willful neglect."[15] Thus, to obtain abatement of employment tax penalties imposed under §§ 6651 and 6656, the taxpayer must bear the heavy burden of proving that (1) the failure did not result from "willful neglect;" and (2) the failure was occasioned by "reasonable cause."[16]

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10. 26 U.S.C. §§ 3102(a), 3402(a).

11. *Id.* § 7501.

12. *Id.* § 3403.

13. *Id.* § 6011(a).

14. *Id.* § 6302; 26 C.F.R. § 301.6302-1.

15. 26 U.S.C. §§ 6651(a)(1), (a)(2), 6656(a).

16. *Boyle*, 469 U.S. at 245, 105 S.Ct. 687.

Neither "willful neglect" nor "reasonable cause" are defined in the IRC.

In *United States v. Boyle*, the Supreme Court defined "willful neglect," as used in § 6651(a)(1), as "a conscious, intentional failure or reckless indifference."[17] Stated differently, the taxpayer must show that the failure to file a return was the result "neither of carelessness, reckless indifference, nor intentional failure."[18]

There is no jurisprudential definition of "reasonable cause;" however, the Treasury Regulations shed some light on its meaning.

1. Failure to File

For failure-to-file situations under § 6651(a), the Treasury Regulations explain:

> If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to reasonable cause.[19]

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17. *Id.* The analysis in *Boyle* only concerned failure-to-file penalties under § 6651(a)(1) and not failure-to-pay or failure-to-deposit penalties under §§ 6651(a)(2) and 6656, respectively. The language concerning the relevant standard is identical in all three provisions. Thus, we find no reason to treat the language in § 6651(a)(1) differently from that in §§ 6651(a)(2) and 6656. *E. Wind*, 196 F.3d at 504 n. 5.

18. *Boyle*, 469 U.S. at 246 n. 4, 105 S.Ct. 687.

19. 26 C.F.R. § 301.6651-1(c)(1).

Appendix A

2. Failure to Pay

For failure-to-pay situations under § 6651(a)(2), the Treasury Regulations explain:

> A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship (as described in § 1.6161-1(b) of this chapter) if he paid on the due date. In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, consideration will be given to *all the facts and circumstances* of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax. Thus, for example, a taxpayer who incurs lavish or extravagant living expenses in an amount such that the remainder of his assets and anticipated income will be insufficient to pay his tax, has not exercised ordinary business care and prudence in providing for the payment of his tax liability. Further, a taxpayer who invests funds in speculative or illiquid assets has not exercised ordinary business

> care and prudence in providing for the payment of his tax liability unless, at the time of the investment, the remainder of the taxpayer's assets and estimated income will be sufficient to pay his tax or it can be reasonably foreseen that the speculative or illiquid investment made by the taxpayer can be utilized (by sale or as security for a loan) to realize sufficient funds to satisfy the tax liability. A taxpayer will be considered to have exercised ordinary business care and prudence if he made reasonable efforts to conserve sufficient assets in marketable form to satisfy his tax liability and nevertheless was unable to pay all or a portion of the tax when it became due.[20]

In addition to the nature of the taxpayer's actions, the nature of the tax at issue must be considered.[FN21] The Treasury Regulations expressly state that "[i]n determining if the taxpayer exercised ordinary reasonable care and prudence in providing for the payment of his tax liability, consideration will be given to the nature of the tax which the taxpayer has failed to pay."[22]

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20. *Id.* § 301.6651-1(c)(1) (emphasis added). "Undue hardship" is "more than inconvenience to the taxpayer. It must appear that substantial financial loss . . . will result to the taxpayer for making payment on the due date. . . ." *Id.* § 1.6161(b).

21. *Id.* § 301.6651-1(c)(2).

22. *Id.*

3. Failure to Deposit

For failure-to-deposit situations under § 6656, the Treasury Regulations neither define nor explain "reasonable cause," but they do explain that the IRS will generally waive the requisite penalty if a taxpayer's failure to deposit was "inadvertent,"[23] requiring that determination of inadvertence must be "based on all the facts and circumstances."[24]

4. Bright-Line Rule or Multi-Factor Test

The first issue on appeal here is whether financial difficulty may ever be a "reasonable cause" for failure to file, pay, or deposit payroll taxes. The government urges us to join the Sixth Circuit and adopt a bright-line rule that financial difficulty may never constitute reasonable cause.[25] In the Sixth Circuit's *Brewery* case, a taxpayer brought a refund action to recover penalties assessed for its failure to pay and to deposit payroll taxes.[26] The taxpayer insisted that

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23. *Id.* § 301.6656-1(a)(1)(i).

24. *Id.* § 301.6656-1(a)(2). It is unclear whether the "inadvertent" standard set forth for § 6656 penalties is identical to the "ordinary business care" standards set forth for §§ 6651(a)(1) and (2) penalties. We need not, however, decide this issue. Whether we determined the "inadvertent" standard was different from or identical to the "ordinary business care" standard, we would still conclude that S.I. lacked reasonable cause in satisfying its payroll tax obligations. Thus, for purposes of this opinion, we will assume that the standards are the same.

25. *Brewery*, 33 F.3d at 592-93.

26. *Id.* at 591.

it had exercised ordinary business care and prudence, but was still not able to satisfy its payroll tax obligations because of financial difficulties.[27] The taxpayer argued that the tax penalties should be abated, as its failure to pay was for reasonable cause.[28] On appeal, the Sixth Circuit concluded that, as payroll taxes are held by the employer in trust for the government and are for the exclusive use of the government, an employer's failure to pay and to deposit the taxes may never, as a matter of law, be excused because of the employer's financial difficulties.[29] Otherwise, reasoned the Sixth Circuit, a taxpayer would be "permitted to self-execute a government loan" or "make the government 'an unwilling partner in a floundering business.' "[30] The government requests that we adopt the Sixth Circuit's *per se* rule for the same reasons espoused in *Brewery.*

In opposition, S.I. urges us to adopt the facts-and-circumstances test ("multi-factor test") employed by the Second, Third, Seventh, and Ninth Circuits. Each of these circuits has rejected *Brewery*'s holding, concluding that the *Brewery* approach would disregard the clear language and purpose of the applicable statutes and regulations, which require a fact-intensive analysis.

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27. *Id.* at 591-92.

28. *Id.*

29. *Id.* at 593.

30. *Id.* (citing *C.J. Rogers, Inc. v. United States*, No. 89-70209, 1990 WL 255586, (E.D.Mich. Sept.17, 1990), and quoting *Collins v. United States*, 848 F.2d 740, 742 (6th Cir.1988)).

We acknowledge the existence of the circuit split on this issue, but need not--and therefore do not—resolve this issue today. This is because, under either the bright-line rule or the multi-factor test, S.I.'s claim for abatement of penalties fails. Thus, for purposes of this appeal, we assume without granting that the multi-factor test applies and proceed to analyze S.I.'s claim accordingly.

5. S.I.'s Claim Under the Multi-Factor Test

A taxpayer has a heavy burden in establishing that it had reasonable cause not to file, pay, or deposit payroll taxes.[31] In fact, this burden is so weighty that, to our knowledge, only one appellate opinion has ever concluded that a taxpayer's failure to pay payroll taxes in a timely fashion was the result of reasonable cause and not willful neglect.[32]

Here, S.I. argues that Compaq's cutbacks, Enron's and Global Crossing's collapses, S.I.'s loss of its financing arrangement with Prinvest, and the problems rampant throughout the financial sector of the national economy following the attacks of September 11, combined to frustrate S.I.'s ability to file, to pay, and to deposit its payroll taxes timely. We do not dispute that S.I. suffered financial difficulties. We do dispute, however, S.I.'s insistence that these difficulties and, more importantly, S.I.'s response to them, constituted reasonable cause for S.I.'s failure to satisfy timely its payroll tax obligations.

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31. *Boyle*, 469 U.S. at 245, 105 S.Ct. 687.

32. *E. Wind*, 196 F.3d at 508-13. In *East Wind*, the taxpayer had only failed to pay, not file or deposit, the payroll taxes in a timely fashion. *Id.*

As for the penalties for failure to *file*, we cannot accept that S.I.'s financial difficulties prevented it from *filing* its payroll tax returns on time. Although S.I.'s financial difficulties may well have affected its ability to pay and to deposit, they certainly had no discernible effect on its ability to file. In fact, S.I. offers no legitimate reason for its failure to file, attempting instead to conflate the failure to file penalties with S.I.'s rationale for failing to pay and to deposit its payroll taxes in a timely manner. It is axiomatic, however, that these imposts penalize different failures and cannot be viewed through the same lens simply because a taxpayer fails to discharge all three duties fully and timely. S.I.'s case is not one in which a taxpayer's financial difficulties prevented it from filing its tax returns, regardless of any inability to pay or to deposit—if such a case even exists. As S.I. has offered no legitimate reason for its failure to file payroll tax returns timely, it is not entitled to abatement of penalties for its failure to file.

As for penalties for failure to pay and failure to deposit, the jurisprudence reflects that the primary factors in determining whether a taxpayer exercised ordinary business care are (1) the taxpayer's favoring of other creditors over the government, which weighs against a finding of reasonable cause, and (2) the taxpayer's willingness to decrease expenses and personnel, which weighs in favor of a finding of reasonable cause.[33]

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33. *E.g.*, *Fran Corp.*, 164 F.3d at 820. When S.I. initially faced its financial difficulties, it made the business decision to "grow" the company, rather than cut its expenses. We are keenly aware that courts should not attempt to judge a company's business decisions with the

(Cont'd)

Appendix A

Despite all its financial troubles in late 2001 and early 2002, S.I. continued to pay virtually all its creditors, its employees, its contractors, its officer-stockholders, and its operating expenses in preference to its payroll tax obligations. S.I. relegated its obligations to the government to those owed to its other creditors and even those owed to its own officer-shareholders. The logical consequence of S.I.'s actions is the imposition of tax penalties. To conclude otherwise would be to sanction S.I.'s unilateral, self-execution of a government loan. We conclude that, like its non-entitlement to abatement of its penalties for failure to file, S.I. is not entitled to an abatement of its failure-to-pay or its failure-to-deposit penalties.[34]

(Cont'd)
illumination of hindsight. Rather, courts should afford a company's business decisions a range of discretion. Here, we will neither second-guess S.I.'s decision to "grow" nor nitpick the expenses that it classified as advertising, marketing, and client-relations efforts, by labeling them as extravagant or lavish. We neither penalize S.I. for its unsuccessful attempt to "grow" its business nor credit its decisions to cut its expenses, which it did extensively only after its attempt to "grow" floundered. Instead, our decision is based solely on S.I.'s conscious, knowing decision to satisfy essentially all of its obligations ahead of its payroll tax obligations.

34. Having concluded that S.I.'s failure to satisfy its payroll tax obligations was without reasonable cause, we need not determine whether it resulted from willful neglect.

Appendix A

III. *CONCLUSION*

Based on the applicable law and our extensive review of the parties' briefs and the record on appeal, we hold that S.I. failed to exercise ordinary business care and prudence in the timely discharge of its payroll tax obligations. S.I.'s failure to do so was not the result of a reasonable cause. Therefore, even when we assume *arguendo* that the multi-factor test is the appropriate one, we conclude that S.I. is not entitled to an abatement of its payroll tax penalties. Accordingly, we affirm the summary judgment of the district court in favor of the government.

AFFIRMED.

APPENDIX B — MEMORANDUM AND OPINION OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF TEXAS, HOUSTON DIVISION DATED FEBRUARY 9, 2006

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

No. Civ.A. H-H-04-2210

STAFF IT INC.,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant.

Feb. 9, 2006

MEMORANDUM AND OPINION

ROSENTHAL, J.

Staff IT, Inc., a Texas corporation, failed to pay all of its employment taxes in 2001 and 2002. The IRS refused to abate the penalties assessed under 26 U.S.C. §§ 6651(a)(2) and 6656 for this failure. Staff IT filed this suit to challenge the IRS's denial of the penalty abatement request. The IRS has moved for summary judgment, asserting that as a matter of law, based on the undisputed evidence in the record, Staff IT cannot make the showings necessary for penalty abatement.

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In its response, Staff IT challenges the IRS's standard for determining whether penalties can be abated when financial hardship is the reason for the failure to make a timely payment of the employment taxes. Staff IT argues that it has raised fact issues precluding summary judgment. Based on the record, the motions and responses, and the applicable law, this court grants the IRS's motion for summary judgment, for the reasons explained below.

I. Background

The summary judgment record includes an affidavit from Staff IT's president, chief accounting and financial officer, and 40 percent shareholder, Rick McMinn, as well as portions of his deposition testimony. McMinn provided a detailed description of the history of Staff IT and the reasons it failed to pay employment taxes in the quarters at issue. The relevant financial and accounting records are also part of the record.

Staff IT is an accrual basis taxpayer based in Houston, Texas. It was incorporated in 1996 as a staffing company to procure computer programmers and other technical personnel for outside businesses. The businesses would typically hire Staff IT to locate temporary or contract personnel to fill computer programming or other technical positions. Once located, the individual workers, known as "contractors," would be put on Staff IT's payroll, but work under the client's direction. Each pay period, Staff IT would pay the individual contractors, withholding payroll taxes. Staff IT would invoice the client for the services the contractors provided, including a surcharge of approximately 30 percent. A client would usually pay 30 to 60 days after the invoice is sent. The gap

between Staff IT's payment to contractors and the receipt of payment from clients delayed Staff IT's access to cash flow from these invoices. Staff IT addressed the delay by borrowing from a financing company willing to extend credit despite the fact that Staff IT had no assets to serve as collateral other than its accounts receivable. Such a financing company is known as a "factoring company" and charges a relatively high rate of interest. Staff IT paid its factoring company, Prinvest, an interest rate of approximately 30 percent per annum. Prinvest would forward Staff IT approximately 70 to 80 percent of the invoice amount expected from the client and Staff IT would ask the client to pay Prinvest directly. Staff IT used this money to pay employee salaries and other expenses, including employment taxes. Once Prinvest received payment from Staff IT's client, Prinvest would deduct its fees and forward the remaining amount to Staff IT. (Docket Entry No. 16, Ex. 9 at 14).

By mid-2001, Staff IT had grown to nearly $16 million in annual billings, with over 200 contractors, nearly $1.6 million in accrued monthly revenues, and cash flow of over $2 million per month. Staff IT's payroll tax deposits were nearly $3 million in 2000 and nearly $2 million from January through September 2001. Staff IT timely paid its employment taxes until the last quarter of 2001.

Beginning in May 2001, Staff IT faced a series of financial difficulties. From May through August 2001, Compaq Computer, Staff IT's single largest client, laid off a large part of its workforce, including 55 Staff IT contractors. Staff IT lost $400,000 in revenues as a result. During this same period, Enron and Dynegy laid off 12 contractors hired

from Staff IT. In August 2001, Prinvest, Staff IT's financing company, declared bankruptcy, leaving Staff IT with no financing source.

The effects of the September 11, 2001 terrorist attack on financial markets and business activities caused further reduction in clients' demand for contractors and further difficulties in Staff IT's ability to obtain financing. Staff IT owed money to its former factoring company, Prinvest, which had a secured interest in Staff IT's receivables. In October 2001, Prinvest threatened to exercise its contractual right to call in Staff IT's receivables if it did not receive a $300,000 payment. McMinn, who with the other two Staff IT shareholders had personally guaranteed Prinvest's loan to Staff IT, borrowed $300,000 against his house and loaned the money to Staff IT to pay Prinvest, giving Staff IT time to locate another factoring company. Staff IT repaid McMinn for the loan on the same terms he received from the bank. At the same time, Staff IT continued to pay McMinn's $240,000 annual salary.

Staff IT cut some expenses during this period. Some of these expenses, however, were not eliminated but merely deferred until the following month. In October 2001, Staff IT continued to have contractors work at Enron and Compaq, despite announcements by those companies that they would delay invoice payments. Staff IT asserts that it cut other "G & A" costs—a catch-all category of expenses—including some advertising and recruiting expenses, but no directive to cut expenses issued. (Docket Entry No. 16, Ex. 9, at 47). Staff IT paid $100,000 to creditors besides Prinvest in October 2001. During this period, Staff IT increased

marketing efforts by shifting two staff people from recruiting contractors to selling services. The marketing efforts were part of a plan to overcome the financial difficulties through an "increase in the business in order to be able to catch up." (*Id.* at 71). This growth strategy was the basis for Staff IT's business decisions. (*Id.* at 79-80, 93-94).

In November and December 2001, another Staff IT client, Enron, weakened and eventually went into bankruptcy. Staff IT claims that it lost approximately $450,000 in receivables as a result, a loss it did not pursue in the bankruptcy courts because of the expenses and fees required to do so.

Staff IT failed to make payroll tax deposits in November and December 2001. During this period, Staff IT asserts that it "delayed" payments to certain third-party contractors and on certain debts, but admits that it did not reduce the number of contractors on its payroll, reduce the number of employees, reduce salaries—including those paid to the owners/ shareholders—or issue a broad directive to reduce expenses. At that time, Staff IT was expecting increased business as a result of the increased marketing efforts. Staff IT decided not to pay its payroll tax deposits, which would have resulted in Staff IT running out of cash in November 2001. Instead, Staff IT hoped that new business in 2002 would enable it to pay the past-due fourth-quarter 2001 payroll taxes, as well as make timely deposits of 2002 payroll taxes.

During this period, Staff IT continued to spend money on marketing and advertising efforts and to pay its operating expenses. Staff IT continued to provide monthly vehicle allowances for its employees who had to drive to client sites.

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Staff IT spent money to take clients to professional baseball games; its expenses included $830 in parking for such games. Staff IT spent $3,500 on a Christmas party and spent money on promotional items such as drink "koozies," which it justified as part of its advertising and client relations efforts. Staff IT spent $800 on Christmas hams for its contractors. Staff IT also continued to take clients to meals at Staff IT's expense.

In early 2002, Staff IT's anticipated business increase not only failed to materialize, its existing business declined. Staff IT had still not obtained a replacement financing source. Another Staff IT client, Global Crossing, filed for bankruptcy protection. Staff IT attempted to cut some costs, but negative cash flow outpaced the cost cuts. In February 2002, Staff IT cut some debt payments, reduced rent payments, and reduced payments to third-party contractors. Staff IT continued to pay its contractors and to pay operating expenses. Staff IT made no layoffs and did not reduce salaries or contractor wages. In the absence of a financing source, McMinn loaned another $50,000 to Staff IT. Staff IT did not make any payroll tax deposits in the first two months of 2002. Staff IT believed the downturn to be temporary and hoped that once it secured a new source of financing, it could pay the IRS.

In March and April 2002, Staff IT secured a new financing source. Recognizing the need to reduce expenses, Staff IT did lay off some employees and contractors. Staff IT continued business with its smaller workforce, but cut salaries and costs. Staff IT reduced the salaries of the three officer/shareholders by 57 percent from 2001 levels—reducing pay for each of them from $240,000 to $104,000 in

2002 and 2003. Staff IT cut other employees' salaries by 22 percent over 2001 levels. Staff IT cut the monthly vehicle allowance and the client meals it paid for. Staff IT cut advertising expenses by 18 percent in 2002, and cut them again in 2003, making advertising costs 37 percent less in 2003 than they were in 2001. Before it could obtain financing, Staff IT had to pledge its receivables to the new financing company. To accomplish this, Staff IT first had to pay back the money it owed Prinvest, which had a lien on the receivables. Staff IT paid Prinvest $200,000. Staff IT continued to pay operating costs, but did not resume paying its payroll taxes.

In March and April, Staff IT's monthly accrued revenues, and the number of its contractors working at clients, reached the lowest level. Staff IT did not make any payroll tax deposits until June 2002, when it deposited approximately $93,000 in its IRS account. Staff IT was not generating enough income to pay the IRS for current taxes, much less the back taxes owed.

During the last six months of 2002, Staff IT was paying most of its payroll taxes as they accrued, with the exception of December 2002. In that month, the financing company retained sums and caused Staff IT to fall short on its deposit of payroll taxes. Staff IT did not, however, pay the IRS the back payroll taxes. It met its wages, interest, and operating cost obligations, but owed its attorneys and others over $200,000 at the end of the year.

The IRS issued a Final Notice of Intent to Levy to Staff IT on October 14, 2003 and a Notice of Federal Tax Lien

Filing on November 7, 2003. Staff IT responded by requesting a due process hearing before an IRS Appeals settlement official. In February 17, 2004, the IRS Appeals settlement officer met with Staff IT. Staff IT requested a penalty abatement, as well as an installment plan and account transcript. On April 28, 2004, after a hearing and review of Staff IT's request, the IRS Appeals settlement officer determined that Staff IT failed the standard necessary for penalty abatement, rejected Staff IT's request, and gave Staff IT until May 10, 2004 to satisfy its current compliance requirements. Staff IT asked for an installment plan, which the settlement officer rejected because Staff IT failed to remain in current compliance. IRS Appeals issued a formal denial of the requests for penalty abatement and installment plan on May 13, 2004. Staff IT appealed this determination by filing this suit.

III. The Government's Motion for Summary Judgment

In its response to the IRS's motion for summary judgment, Staff IT waived its claims for relief from the denial of the request for an installment agreement and an account transcript. (Docket Entry No. 23 at 2). The IRS's motion for summary judgment on those issues is granted.[1] The remaining

1. Staff IT has moved to exclude evidence the IRS submitted showing that while this law suit has been pending, Staff IT has failed to pay employment taxes. As of July 2004, Staff IT had accrued delinquent tax liabilities of nearly $1.5 million. Staff IT asserts that this suit relates only to penalty abatement for the failure to pay in the three tax quarters ending December 31, 2001, March 31, 2002, and September 30, 2002. (Docket Entry No. 22). The IRS submitted this evidence in its motion for summary judgment in relation to the installment agreement issue that Staff IT later waived. The motion to exclude is denied as moot.

issue is whether the government is entitled to summary judgment that Staff IT did not make the showing necessary for an abatement of penalties for failing to pay employment taxes for the quarters ending December 31, 2001, March 31, 2002, and September 30, 2002.

A. The Summary Judgment Standard

Summary judgment is appropriate if no genuine issue of material fact exists and the moving party is entitled to judgment as a matter of law. *See* Fed R. Civ. P. 56. Under Rule 56(c), the moving party bears the initial burden of "informing the district court of the basis for its motion, and identifying those portions of [the record] which it believes demonstrate the absence of a genuine issue of material fact." *Celotex Corp. v. Catrett*, 477 U.S. 317, 322, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986); *Stahl v. Novartis Pharms. Corp.*, 283 F.3d 254, 263 (5th Cir.2002). If the burden of proof at trial lies with the nonmoving party, the movant may either (1) submit evidentiary documents that negate the existence of some material element of the opponent's claim or defense, or (2) if the crucial issue is one on which the opponent will bear the ultimate burden of proof at trial, demonstrate the evidence in the record insufficiently supports an essential element or claim. *Celotex*, 477 U.S. at 330. The party moving for summary judgment must demonstrate the absence of a genuine issue of material fact, but need not negate the elements of the nonmovant's case. *Bourdeaux v. Swift Transp. Co., Inc.*, 402 F.3d 536, 540 (5th Cir.2005). "An issue is material if its resolution could affect the outcome of the action." *Weeks Marine, Inc. v. Fireman's Fund Ins. Co.*, 340 F.3d 233, 235 (5th Cir.2003) (citing *Anderson v. Liberty*

Lobby, Inc., 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986)). If the moving party fails to meet its initial burden, the motion for summary judgment must be denied, regardless of the nonmovant's response. *Baton Rouge Oil & Chem. Workers Union v. ExxonMobil Corp.*, 289 F.3d 373, 375 (5th Cir.2002).

When the moving party has met its Rule 56(c) burden, the nonmoving party cannot survive a motion for summary judgment by resting on the mere allegations of its pleadings. The nonmovant must identify specific evidence in the record and articulate the manner in which that evidence supports that party's claim. *Johnson v. Deep E. Tex. Reg'l Narcotics Trafficking Task Force*, 379 F.3d 293, 305 (5th Cir.2004). The nonmovant must do more than show that there is some metaphysical doubt as to the material facts. *Armstrong v. Am. Home Shield Corp.*, 333 F.3d 566, 568 (5th Cir.2003).

In deciding a summary judgment motion, the court draws all reasonable inferences in the light most favorable to the nonmoving party. *Calbillo v. Cavender Oldsmobile, Inc.*, 288 F.3d 721, 725 (5th Cir.2002); *Anderson*, 477 U.S. at 255. "Rule 56 '*mandates* the entry of summary judgment, after adequate time for discovery, and upon motion, against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial.'" *Little v. Liquid Air Corp.*, 37 F.3d 1069, 1075 (5th Cir.1994) (quoting *Celotex*, 477 U.S. at 322).

In this case, the taxpayer bears the burden of proof on whether it is entitled to have the penalties for nonpayment

abated. The IRS has the burdens of a summary judgment movant. The facts and inferences must be reviewed in the light most favorable to Staff IT to determine whether there is a genuine issue of material fact. If there is no genuine issue of material fact, the question is whether the IRS is entitled to judgment as a matter of law. *E. Wind Indus., Inc. v. United States*, 196 F.3d 499, 504 (3d Cir.1999).

B. The Standard for Penalty Abatement

Sections 3102(a) and 3402(a) of the Internal Revenue Code require an employer to deduct and withhold income and social security taxes from its employees' wages. Section 7501 of the Internal Revenue Code provides that these taxes must be held by the employer as a special trust fund for the benefit of the United States. Section 3403 provides that the employer is liable for the payment of the taxes required to be withheld under Sections 3102 and 3402. The employer is required to report the amount of withheld taxes on its payroll tax return, Form 941. This return and a payment of employment taxes is due every calendar quarter. I.R.C. § 6011(a). An employer is required to deposit the employment and income taxes withheld in an approved bank at various intervals during a calendar quarter, depending on how much is withheld. I.R.C. § 6302 and 26 C.F.R. § 301.6302-1.

The IRS imposes mandatory penalties for failing to file returns, pay taxes, or deposit employment taxes in a government depository, unless the taxpayer can show that such failure was due to "reasonable cause" and not due to "willful neglect." 26 U.S.C. §§ 6651(a)(1), (a)(2), 6656(a). Interpreting Section 6651(a)(1), the Supreme Court held that

the taxpayer bears the "heavy burden of proving both (1) that the failure did not result from 'willful neglect,' and (2) that the failure was 'due to reasonable cause.'" *United States v. Boyle*, 469 U.S. 241, 245, 105 S.Ct. 687, 83 L.Ed.2d 622 (1985). In *Boyle*, the Court interpreted "willful neglect" to mean "a conscious, intentional failure or reckless indifference."[2]

"Reasonable cause" is not defined in the Internal Revenue Code. The Treasury Regulations interpreting the "reasonable cause" provision of Section 6651 reads, in pertinent part:

> If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause. A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship (as described in § 1.6161-1(b) of this chapter) if he paid on the due date.

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2. The Court's analysis in *Boyle* addressed penalties for failure to file tax returns under Section 6651(a)(1). The language concerning the standard for failure to file a return is identical to the language in Sections 6651(a)(2) and 6656 for failure to pay and to deposit. The courts have applied *Boyle* to taxpayer challenges to penalties for failure to pay or deposit taxes under Sections 6651(a)(2) and 6656. *See, e.g., E. Wind Indus., Inc.*, 196 F.3d at 504 n. 5; *Fran Corp. v. United States*, 164 F.3d 814, 816 n. 2 (2d Cir.1999).

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26 C.F.R. § 301.6651-1(c)(1). An "undue hardship" is defined as:

> more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, loss due to the sale of property at a sacrifice price, will result to the taxpayer for making payment on the due date of the amount with respect to which the extension is desired. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

26 C.F.R. § 1.6161-1(b). To assess the evidentiary basis for a finding of "reasonable cause,"

> consideration will be given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax.

26 C.F.R. § 301.6651-1(c)(1).

In this analysis, "lavish or extravagant expenses" or investments in "speculative or illiquid assets" that render a taxpayer's remaining assets insufficient to satisfy its tax obligations demonstrate a failure to exercise ordinary business care and prudence. *Id.* Section 301.6651-1(c)(2) of the Regulations provides:

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> In determining if the taxpayer exercised ordinary business care and prudence in providing for the payment of his tax liability, consideration will be given to the nature of the tax which the taxpayer has failed to pay. Thus, for example, facts and circumstances which, because of the taxpayer's efforts to conserve assets in marketable form, may constitute reasonable cause for nonpayment of income taxes may not constitute reasonable cause for failure to pay over taxes described in section 7501 that are collected or withheld from any other person.

26 C.F.R. § 301.6651-1(c)(2).[3]

The taxes at issue in this case are described in Section 7501. As noted, the employee portion of those taxes, collected or withheld by the employer as salaries are paid, are held in a "special fund in trust for the United States." 26 U.S.C. § 7501(a). The parties dispute the standard to be applied when financial difficulties are presented as "reasonable cause" to avoid the penalties for failing to pay "trust fund" employment taxes. The government urges this court to adopt the standard set by the Sixth Circuit in *Brewery, Inc. v. United States*, 33 F.3d 589 (6th Cir.1994), which held that "financial difficulties can never constitute reasonable cause to excuse the penalties

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3. In addition, the IRS has identified certain specific reasons for the late filing of a return which, if established by the taxpayer, will be accepted as "reasonable cause." *See Roberts v. Comm'r of Internal Revenue*, 860 F.2d 1235, 1241 (5th Cir.1988) (citing Internal Revenue Manual (CCH) § 4562.2). None of these specific circumstances is present here.

for nonpayment of withholding taxes by an employer." *Id.* at 592 (citation omitted). The *Brewery* court based this bright-line rule on both the trust language of Section 7501 of the statute and Section 301.6651-1(c)(2) of the Regulations, which provides through an example that failure to pay an employer's own income taxes may be easier to justify under the "reasonable cause" standard than a similar failure to pay trust fund taxes. The court interpreted this regulation to mean that a heightened standard applied for reasonable cause for a failure to deposit or pay employment taxes, which are funds held in trust for the United States under 26 U.S.C. § 7501. *Id.* Given this heightened standard, the Sixth Circuit held that "the use of trust funds for the payment of other creditors cannot, as a matter of law, constitute reasonable cause to excuse the penalties for nonpayment of withholding taxes by an employer." *Id.*

The Second, Third, and Ninth Circuits have rejected this bright-line test. These courts have found that such a rule is inconsistent with the "reasonable cause" standard and the Treasury Regulations that require courts to assess "all the facts and circumstances" to determine whether the taxpayer exercised ordinary business care and prudence in providing for its payroll tax obligation. *See, e.g., Van Camp & Bennion v. United States*, 251 F.3d 862 (9th Cir.2001); *E. Wind Indus.*, 196 F.3d at 507-09; *Fran Corp.*, 164 F.3d at 820. The majority rule rejects this bright-line test in favor of a multifactor approach to the "reasonable cause" analysis. Those courts have held that the "reasonable cause" analysis must flow from "a factual assessment of the taxpayer's financial situation to determine whether it has exercised ordinary business care and prudence in responding to competing financial obligations." *Fran Corp.*, 164 F.3d at 819.

This disagreement among the circuits affects the analysis more than the outcome of most cases. The same courts rejecting *Brewery*'s bright-line approach agree that the circumstances must be compelling for financial concerns to constitute reasonable cause to abate penalties for nonpayment of employment taxes. *Van Camp & Bennion*, 251 F.3d at 868; *E. Wind Indus., Inc.*, 196 F.3d at 508; *Fran Corp.*, 164 F.3d at 819. "We recognize that it will be the rare case where the government is made the 'unwilling partner in a floundering business,' without the employer incurring the duty to pay a penalty for having made such a choice, but it nonetheless remains for the court in each case to weigh all of the factors identified in the Regulations." *Fran Corp.*, 164 F.3d at 819 (quoting *Brewery*, 33 F.3d at 593 (additional quotations and citations omitted)).

Only one reported appellate case has found that a taxpayer's failure to pay and deposit employment taxes timely was due to reasonable cause and not willful neglect. In that case, the taxpayer's financial viability and cash flow was dependent on government contracts. Corrupt government employees demanded bribes from the taxpayer as a condition of receiving the contracts. The court held that the government was "not an unwilling partner in a floundering business, but an active participant." *E. Wind Indus.*, 196 F.3d at 508. The court went on to emphasize that the taxpayer only paid those creditors and a small number of employees whose services were essential to operating its business at a minimal level in order to collect monies contractually due so they could pay the IRS; the owners incurred substantial debts, including a mortgage on their home and other personal loans, to provide additional cash for the taxpayer to remain in business to

collect the money necessary to pay the IRS; and the taxpayer did not pay operating expenses, including rent. *Id.* at 509. Based on these factors, the court concluded that choosing to pay these creditors over the trust fund taxes did not amount to willful neglect.

The Fifth Circuit has not weighed in on the dispute among the circuits. This case does not require this court to choose sides.[4] Under either the bright-line test or the multifactor test, the IRS is entitled to summary judgment.

III. Analysis

Staff IT claims that the disruption of its business with Compaq, the collapse of Enron, WorldCom, and Global Crossings, the loss of its financing arrangement with Prinvest, and the problems in the financial sector after 9/11 combined to frustrate its ability to pay its payroll taxes. Staff IT has presented undisputed evidence of financial troubles. The case law uniformly holds that such evidence is by itself inadequate to raise a fact issue that a failure to make timely payroll tax deposits was due to reasonable cause rather than willful neglect.

4. This court, however, respectfully notes its disagreement with the Third Circuit's public policy basis for interpreting Section 301.6651(c)(1) of the Treasury Regulations. *Compare E. Wind Indus., Inc.*, 196 F.3d at 509 *with id.* at 513 (Stapleton, J., dissenting) ("Contrary to the Court's suggestion, § 301.6651-1(c)(1) does not create a general 'ordinary business care and prudence' standard for judging how a taxpayer has conducted its business. It speaks solely to situations in which the taxpayer has (or has not) 'exercised ordinary business care and prudence *in providing for payment of his tax liability*,' only to have his efforts thereafter frustrated by events beyond his control." (emphasis added in original)).

Appendix B

Staff IT justifies its choice to pay creditors over its employment taxes because of its financial difficulties. The evidence as to Staff IT's income and expenses is undisputed. Under the *Brewer* approach, the IRS is entitled to judgment as a matter of law because financial hardship cannot show a reasonable cause for failing to pay employment taxes when due. Under the multifactor analysis, this court must consider whether Staff IT has raised a fact issue as to whether it exercised ordinary business care and prudence in providing for the payment of its tax liability. This in turn requires examination of the amount and nature of Staff IT's expenditures in light of the amounts it could reasonably expect to receive before the taxes were due. Courts applying the multifactor test look to the taxpayer's expenditures before and after the taxpayer failed to pay its withholding taxes and the taxpayer's treatment of other creditors vis-à-vis the IRS.

Staff IT faced severe financial difficulties beginning in May 2001. From May to August, Staff IT had a 50 percent drop in its business and its finance company filed for bankruptcy. Staff IT knew that its dependence on the "factor" made it financially vulnerable and would significantly affect its cash flow. The events of 9/11 had immediate and obvious effects on the economy, which Staff IT felt. In October 2001, Staff IT did not pay employment taxes. Nor did it reduce contractors, lay off employees, reduce salaries paid to its officer/shareholders, or take significant steps to cut costs. Instead, Staff IT increased marketing efforts.

In November and December 2001, Staff IT did not make payroll tax deposits. Staff IT asserts that it would have run out of cash in November had it paid "all" of the taxes, but

still did not take aggressive steps to reduce its costs. As McMinn testified, Staff IT wanted to grow and expand, to fill in the "big hole" created by the loss of Compaq and Enron business. (Docket Entry No. 16, Ex. 9 at 95). Pursuing this strategy of expansion, Staff IT did not lay off employees, reduce the number of contractors, or reduce the salaries it paid. Staff IT continued to pay monthly vehicle allowances, threw a holiday party at a cost of $3,500, distributed $800 worth of holiday hams, continued to take clients to lunch, and continued to distribute promotional merchandise to clients. Although McMinn argued that client relations and contractor loyalty were important in this competitive field, he also admitted in his deposition that most of these expenses were not essential to the company's survival.

In the first quarter of 2002, Staff IT's business continued to decline. No payroll tax deposits were made. Yet Staff IT did not lay off any employees until March and April. Staff IT did not cut officers' compensation or salaries until April 2002. Staff IT did not reduce advertising expenses until March and April 2002. Staff IT did not cut the vehicle allowance or client lunches until April 2002. Throughout this period, Staff IT continued to pay general operating expenses, such as rent, air conditioning, and heating. In the third quarter of 2002, Staff IT deposited a portion of what it owed and continued to operate its business, hoping to sell the company when the market improved.

This court concludes that Staff IT has not raised a triable issue as to whether its failure to make timely payroll deposits was due to reasonable cause and not willful neglect. Staff IT's strongest evidence of "reasonable cause" is the fact that

McMinn himself made contributions from his personal finances, contributing over $350,000 to keep Staff IT afloat. But Staff IT used the funds McMinn contributed to pay other creditors, not the IRS, in the hope that the company would grow past its financial problems, and, later, hang on until it could find a rescuing buyer. McMinn conceded that Staff IT had paid nearly all of its operating expenses—including timely debt payments to McMinn—but nevertheless failed to pass the employment taxes it had collected to the IRS. (Docket Entry No. 16, Ex. 9 at 88).

A finding that the taxpayer prefers other nonessential creditors over the IRS weighs against a finding of "reasonable cause." *See Fran Corp.*, 164 F.3d at 819 (finding that continued rental payments to the company president who had an outstanding loan of nearly $150,000 from the company, the company's decision to fund new auto leases and pay for repairs to existing company cars, and spending over $15,000 in entertainment expenses instead of repaying the IRS failed to demonstrate "reasonable cause"); *In re Frederick Savage, Inc.*, 179 B.R. 342 (Bankr.S.D.Fla.1995) ("[M]ere financial difficulties or cash flow problems are insufficient to establish 'reasonable cause' by virtue of financial disability. This is particularly clear where, as here, the corporate taxpayer continued its business operations as a going concern during the six quarters at issue, but chose to pay creditors other than the United States.") (citing *Wolfe v. United States*, 612 F.Supp. 605, 608 (D.Mont.1985), *aff'd*, 798 F.2d 1241 (9th Cir.1986)). Favoring other creditors over the IRS can also indicate willful neglect. *See, e.g., Brewery, Inc.*, 33 F.3d at 591, 593; *C.J. Rogers v. United States*, No. 89-70209, 1990 WL 25586, at *2 (E.D.Mich. Sept. 17, 1990). In the fourth

quarter of 2001 and first quarter of 2002, despite the heavy loss of business because several of its major clients had encountered financial problems, despite the significant cash flow problems resulting from the bankruptcy of its financing company, Staff IT chose to continue paying virtually all its creditors, its employees' and officers' salaries and wages, and its operating expenses over the payroll tax obligation.

A taxpayer's willingness to cut costs and personnel is also highly relevant. *See In re McTyre Trucking Co., Inc.*, 223 B.R. 588, 594 (Bankr.M.D.Fla.1998) (determining that the debtor had not established reasonable cause in exercising ordinary business care and prudence when the company president, with full knowledge of the nonpayment, continued to pay himself and his wife more than $1 million in salary over six years, continued to reside at a 200-acre ranch without using the property as collateral, waited six years to lay off workers, and compensated company insiders for over seven years after the company's alleged "financial hardships" began). Staff IT blames the loss of business beginning in May 2001, the bankruptcy of its finance company in August 2001, and the effects of 9/11, for its failure to make payroll tax deposits beginning in October 2001. Yet Staff IT delayed significant personnel reductions, salary reductions, or expense reductions until March and April 2002. Until April 2002, Staff IT continued to pay its officers the same salaries ($240,000 each). Staff IT retained its employees and contractors. Staff IT continued to pay such nonessential expenses as Christmas parties, client entertainment, and client lunches. Unlike the taxpayer in *East Wind*, Staff IT did not pay only essential creditors and a small number of employees to keep the business operating at a minimal level to collect

monies that were due to pay the IRS. Instead, Staff IT attempted to "grow" the company and paid expenses toward that goal rather than its payroll tax obligation. When Staff IT finally did make personnel and expense cuts, it was too late to enable it to provide for the payment of its tax liabilities in the final quarter at issue. The undisputed evidence shows that Staff IT did not exercise ordinary car and prudence in arranging to pay its tax liability in any of the quarters at issue.

IV. Conclusion

The record fails to raise a fact issue as to whether Staff IT had a reasonable cause for failing to pay its trust fund taxes when due and as to whether the failure was not due to willful neglect. The government's motion for summary judgment is granted. Final judgment is entered by separate order.

APPENDIX C — STATUTES AND REGULATIONS CITED

Statutes

11 U.S.C § 507(a)(8)(C). Priorities

(a) The following expenses and claims have priority in the following order:

* * *

(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for—

* * *

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

in this paragraph and in compensation for actual pecuniary loss.

11 U.S.C. § 523(a)(1)(A). Exceptions to discharge

(a) A discharge under section 727, 1141, 1228 (a), 1228 (b), or 1328 (b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507 (a)(2) or 507 (a)(8) of this title, whether or not a claim for such tax was filed or allowed;

Appendix C

26 U.S.C. § 3101(a). Rate of tax

(a) OLD-AGE, SURVIVORS, AND DISABILITY INSURANCE

In addition to other taxes, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b))—

IN CASES OF WAGES RECEIVED DURING:	THE RATE SHALL BE:
1984, 1985, 1986, or 1987	5.7 percent
1988 or 1989	6.06 percent
1990 or thereafter	6.2 percent.

26 U.S.C. § 3101(b)(6). Rate of tax

(b) HOSPITAL INSURANCE

In addition to the tax imposed by the preceding subsection, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b))—

* * *

(6) with respect to wages received after December 31, 1985, the rate shall be 1.45 percent.

Appendix C

26 U.S.C. § 3111(a). Rate of tax

(a) OLD-AGE, SURVIVORS, AND DISABILITY INSURANCE

In addition to other taxes, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b))—

IN CASES OF WAGES PAID DURING:	THE RATE SHALL BE:
1984, 1985, 1986, or 1987	5.7 percent
1988 or 1989	6.06 percent
1990 or thereafter	6.2 percent.

26 U.S.C. § 3111(b)(6). Rate of tax

(b) HOSPITAL INSURANCE

* * *

In addition to the tax imposed by the preceding subsection, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b))—

(6) with respect to wages paid after December 31, 1985, the rate shall be 1.45 percent.

Appendix C

26 U.S.C. § 6330(d)(1).

Notice and opportunity for hearing before levy

(d) Proceeding after hearing

(1) Judicial review of determination

The person may, within 30 days of a determination under this section, appeal such determination—

(A) to the Tax Court (and the Tax Court shall have jurisdiction with respect to such matter); or

(B) if the Tax Court does not have jurisdiction of the underlying tax liability, to a district court of the United States.

If a court determines that the appeal was to an incorrect court, a person shall have 30 days after the court determination to file such appeal with the correct court.

26 U.S.C. § 6502(a)(1). Collection after assessment

(a) LENGTH OF PERIOD

Where the assessment of any tax imposed by this title has been made within the period of limitation properly applicable thereto, such tax may be collected by levy or by a proceeding in court, but only if the levy is made or the proceeding begun—

(1) within 10 years after the assessment of the tax . . .

Appendix C

26 U.S.C. § 6651(a)(1) and (2). Failure to file tax return or to pay tax

(a) ADDITION TO THE TAX

In case of failure—

(1) to file any return required under authority of subchapter A of chapter 61 * * * on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate;

(2) to pay the amount shown on tax on any return specified in paragraph (1) on or before the date prescribed for payment of such tax (determined with regard to any extension of time for payment), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount shown as tax on such return 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate; * * *

Appendix C

26 U.S.C. § 6656(a) and (b). Failure to make deposit of taxes

(a) UNDERPAYMENT OF DEPOSITS

In the case of any failure by any person to deposit (as required by this title or by regulations of the Secretary under this title) on the date prescribed therefor any amount of tax imposed by this title in such government depository as is authorized under section 6302(c) to receive such deposit, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be imposed upon such person a penalty equal to the applicable percentage of the amount of the underpayment.

(b) DEFINITIONS

For purposes of subsection (a)—

(1) APPLICABLE PERCENTAGE

(A) IN GENERAL

Except as provided in subparagraph (B), the term "applicable percentage" means—

(i) 2 percent if the failure is for not more than 5 days,

(ii) 5 percent if the failure is for more than 5 days but not more than 15 days, and

(iii) 10 percent if the failure is for more than 15 days.

Appendix C

(B) SPECIAL RULE

In any case where the tax is not deposited on or before the earlier of—

(i) the day 10 days after the date of the first delinquency notice to the taxpayer under section 6303, or

(ii) the day on which notice and demand for immediate payment is given under section 6861 or 6862 or the last sentence of section 6331(a),

the applicable percentage shall be 15 percent.

(2) UNDERPAYMENT

The term "underpayment" means the excess of the amount of the tax required to be deposited over the amount, if any, thereof deposited on or before the date prescribed therefor.

Appendix C

26 U.S.C. § 6672(a). Failure to collect and pay over tax, or attempt to evade or defeat tax

(a) GENERAL RULE

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 or part II of subchapter A of chapter 68 for any offense to which this section is applicable.

26 U.S.C. § 7402(a). Jurisdiction of district courts

(a) TO ISSUE ORDERS, PROCESSES, AND JUDGMENTS

The district courts of the United States at the instance of the United States shall have such jurisdiction to make and issue in civil actions, writs and orders of injunction, and of NE EXEAT REPUBLICA, orders appointing receivers, and such other orders and processes, and to render such judgments and decrees as may be necessary or appropriate for the enforcement of the internal revenue laws. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such laws.

Appendix C

26 U.S.C. § 7501(a). Liability for taxes withheld or collected

(a) GENERAL RULE

Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

28 U.S.C. § 1340. Internal revenue; customs duties

The district courts shall have original jurisdiction of any civil action arising under any Act of Congress providing for internal revenue, or revenue from imports or tonnage except matters within the jurisdiction of the Court of International Trade

28 U.S.C. § 2101(c). Supreme Court; time for appeal or certiorari; docketing; stay

(c) Any other appeal or any writ of certiorari intended to bring any judgment or decree in a civil action, suit or proceeding before the Supreme Court for review shall be taken or applied for within ninety days after the entry of such judgment or decree . . .

Appendix C

Regulations

26 C.F.R. § 301.6651-1(a)(2). [Penalties for] Failure to file tax return or to pay tax.

(2) FAILURE TO PAY TAX SHOWN ON RETURN. In case of failure to pay the amount shown as tax on any return (required to be filed after December 31, 1969, without regard to any extension of time for filing thereof) specified in subparagraph (1) of this paragraph (a), on or before the date prescribed for payment of such tax (determined with regard to any extension of time for payment), there shall be added to the tax shown on the return the amount specified below unless the failure to pay the tax within the prescribed time is shown to the satisfaction of the district director, or, as provided in paragraph (a) of this section, the Assistant Regional Commissioner (Alcohol, Tobacco and Firearms), the director of the service center, to be due to reasonable cause and not to willful neglect. Except as provided in paragraph (a)(4) of this section, the amount to be added to the tax is 0.5 percent of the amount of tax shown on the return if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which the failure continues, but not to exceed 25 percent in the aggregate.

Appendix C

26 C.F.R. § 301.6651-1(c)(1) and (2). [Penalties for] Failure to file tax return or to pay tax.

(c) SHOWING OF REASONABLE CAUSE.

(1) *** a taxpayer who wishes to avoid the addition to the tax for failure to file a tax return or pay tax must make an affirmative showing of all facts alleged as a reasonable cause for his failure to file such return or pay such tax on time in the form of a written statement containing a declaration that it is made under penalties of perjury. Such statement should be filed with the district director or the director of the service center with whom the return is required to be filed; * * * If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause. A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship (as described in Section 1.6161-1(b) of this chapter) if he paid on the due date. In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, consideration will be given to all the facts and circumstances of the

taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax. Thus, for example, a taxpayer who incurs lavish or extravagant living expenses in an amount such that the remainder of his assets and anticipated income will be insufficient to pay his tax, has not exercised ordinary business care and prudence in providing for the payment of his tax liability. Further, a taxpayer who invests funds in speculative or illiquid assets has not exercised ordinary business care and prudence in providing for the payment of his tax liability unless, at the time of the investment, the remainder of the taxpayer's assets and estimated income will be sufficient to pay his tax or it can be reasonably foreseen that the speculative or illiquid investment made by the taxpayer can be utilized (by sale or as security for a loan) to realize sufficient funds to satisfy the tax liability. A taxpayer will be considered to have exercised ordinary business care and prudence if he made reasonable efforts to conserve sufficient assets in marketable form to satisfy his tax liability and nevertheless was unable to pay all or a portion of the tax when it became due.

(2) In determining if the taxpayer exercised ordinary business care and prudence in providing for the payment of his tax liability, consideration

will be given to the nature of the tax which the taxpayer has failed to pay. Thus, for example, facts and circumstances which, because of the taxpayer's efforts to conserve assets in marketable form, may constitute reasonable cause for nonpayment of income taxes may not constitute reasonable cause for failure to pay over taxes described in section 7501 that are collected or withheld from any other person.

26 C.F.R. § 301.6656-1(a) and (b). Penalty for underpayment of deposits.

(a) GENERAL RULE. If any person is required by the Code or regulations prescribed thereunder to deposit any tax in a government depositary that is authorized under section 6302(c) to receive the deposit, and fails to deposit the tax within the time prescribed therefor, a penalty shall be imposed on such person unless the failure is shown to be due to reasonable cause and not due to willful neglect. The penalty shall be 5 percent of the amount of the underpayment without regard to the period during which the underpayment continues. For purposes of this section, the term "underpayment" means the amount of tax required to be deposited less the amount, if any, that was deposited on or before the date prescribed therefor. Section 7502(e) applies in determining the date a deposit is made.

(b) ASSERTION OF REASONABLE CAUSE. To show that the underpayment was due to reasonable cause and not due to willful neglect, a taxpayer must

make an affirmative showing of all facts alleged as a reasonable cause in a written statement containing a declaration that it is made under the penalties of perjury. The statement must be filed with the district director for the district or the director of the service center where the return with respect to the tax is required to be filed. If the district director or the director of the service center determines that the underpayment was due to reasonable cause and not due to willful neglect, the penalty will not be imposed.

26 C.F.R. § 301.6656-3(a)(1). Abatement of penalty.

(a) EXCEPTION FOR FIRST TIME DEPOSITORS OF EMPLOYMENT TAXES—

(1) WAIVER. The Secretary will generally waive the penalty imposed by section 6656(a) on a person's failure to deposit any employment tax under subtitle C of the Internal Revenue Code if—

(i) The failure is inadvertent;

(ii) The person meets the requirements referred to in section 7430(c)(4)(A)(ii) (relating to the net worth requirements applicable for awards of attorney's fees);

(iii) The failure occurs during the first quarter that the person is required to deposit any employment tax; and(iv) The return of the tax is filed on or before the due date; and

(iv) The return of the tax is filed on or before the due date.

26 C.F.R. § 1.6161-1(b). Extension of time for paying tax or deficiency.

(b) UNDUE HARDSHIP REQUIRED FOR EXTENSION. An extension of the time for payment shall be granted only upon a satisfactory showing that payment on the due date of the amount with respect to which the extension is desired will result in an undue hardship. The extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, loss due to the sale of property at a sacrifice price, will result to the taxpayer for making payment on the due date of the amount with respect to which the extension is desired. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

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(3)

No. 07-221

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IN THE

Supreme Court of the United States

STAFF IT, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF OF AMERICAN PAYROLL ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether federal courts should consider all facts and circumstances outlined in Treasury Regulations when determining if "reasonable cause" exists to justify abatement of penalties for an employer's failure to pay payroll taxes under 26 U.S.C. § 6651(a)(2), or its failure to deposit payroll taxes under 26 U.S.C. § 6656(a).

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BRIEF OF AMERICAN PAYROLL ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF THE *AMICUS CURIAE*

The American Payroll Association submits this brief as *amicus curiae* in support of Petitioner in the above-captioned matter.[1]

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary

The American Payroll Association ("APA") is a non-profit association representing payroll professionals. APA's members include over 23,000 payroll professionals, most of whom perform payroll-processing duties for approximately 17,000 employers. Additionally, APA's membership includes representatives of large, medium, and small payroll service providers who in turn process payrolls for an additional 1.5 million employers representing an aggregate total of one-third of the private sector workforce. The employers for whom APA members process payrolls are diverse in terms of business size, location, and industry. As payroll specialists, APA's members must determine proper employment tax withholding, prepare and file accurate information returns and statements, correct (when necessary) such information returns and statements, calculate and deposit taxes, and maintain all necessary payroll records. APA is concerned that the lower court's narrow application of the "reasonable cause" test for the abatement of penalties, which conflicts with both the statute and underlying regulations, would created undue hardship on its members. Accordingly, APA has a direct stake in the outcome of this case.

STATEMENT OF THE CASE

Petitioner Staff IT, Inc., engaged in the business of hiring and paying technical contractors and staffing them to outside business clients. These clients would pay Petitioner for the services. In 2001, the dot-com crash and the collapse of Enron triggered a severe economic downturn, particularly in Houston, where Petitioner encountered reduced demand for its contractors. Petitioner's financing company also declared bankruptcy.

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contribution to the preparation or submission of this brief. Written consent of the Petitioner and Respondent have been obtained and filed with the Clerk of the Court.

At that time Petitioner failed for three quarters to file, pay, and deposit payroll taxes as required by federal law. Petitioner did not scale back expenses until early 2002 when new financing was arranged. The company stabilized its finances by the end of 2002 and began to assume its tax obligations. However, the IRS pursued penalties, which are the subject of this appeal.

Petitioner presented a request to abate the penalties, which an IRS Appeals Officer denied. Petitioner then commenced suit in the District Court, which granted summary judgment for the government. *See United States v. Staff IT, Inc.*, 2006 WL 314440 (S.D. Tex. Feb. 9, 2006). In March 2007, the United States Court of Appeals for the Fifth Circuit affirmed. *See Staff IT, Inc. v. United States*, 482 F.3d 792 (5th Cir. 2007).

SUMMARY OF ARGUMENT

The lower court in this case held that neither "reasonable cause" nor "undue hardship" is present where a taxpayer fails to fire employees and cease all payments to creditors. This holding conflicts with both the statute and underlying regulations, and it ignores the Congressional intent and Internal Revenue Service ("IRS") policy for imposing tax penalties.

This petition involves only the failure to pay and the failure to deposit penalties, not the failure to file penalty. Whether or not a trier of fact determines that the conduct of this Petitioner ultimately excludes it from abatement of those two penalties, however, this court should grant the petition because Petitioner is correct in arguing that the lower court used an improperly narrow test that conflicts with the statute. Furthermore, substantial case law requires the IRS to follow its own regulations. The IRS should be prohibited from advocating a position that is directly contrary to 26 C.F.R. § 301.6651-1(c)(1).

ARGUMENT

I. THE FIFTH CIRCUIT'S HOLDING IS CONTRARY TO THE POLICY UNDERLYING TAX PENALTIES.

Sections 6651(a) and 6656(a) provide that the late filing penalty will not be imposed where the "failure is due to reasonable cause." "Reasonable cause" for a failure to pay is defined in the Treasury Regulations to include situations where the taxpayer's payment of the tax would result in undue financial hardship. 26 C.F.R. § 301.6651-1(c); 26 C.F.R. § 1.6161-1(b). Guidance on the policy behind these penalties and the reasonable cause standard can be discerned from the IRS's own Internal Revenue Manual ("IRM").

In 1987, the IRS formed a task force to study civil penalties and to address the systemic concern that penalties were not being imposed and enforced consistently among taxpayers. That task force, in conjunction with the overhaul of the penalty regime by the Omnibus Budget Reconciliation Act of 1989, resulted in the 1992 adoption of the Service's first penalty policy, P-1-18. This policy is incorporated in the current version of the IRM.

The IRM makes clear that the purpose of penalties is to support and encourage voluntary compliance. *See* IRM 20.1.1.2.1. According to the IRM, each case should be resolved in a manner that promotes voluntary compliance. IRM 20.1.1.1.4(4), Step 8. *See also* IRM 20.1.1.2.1(1) (penalties exist to encourage voluntary compliance); IRM 20.1.1.2.1(5) (penalties advance the mission of the Service when they encourage voluntary compliance). Voluntary compliance is achieved when a taxpayer makes a good faith effort to meet the

requirements of the law. IRM 20.1.1.2.1(6). The IRM acknowledges that taxpayers sometimes take sufficient action to meet their obligations, but as a consequence of factors beyond their control, are unable to do so. Critical to the reasonable cause determination is whether "the taxpayer exercises ordinary care and prudence but, due to circumstances beyond the taxpayer's control, the taxpayer was unable to timely meet the tax obligation." IRM 20.1.1.3.1.2(2)d.

Imposing penalties where the taxpayer's failure to pay was caused by financial distress is contrary to the IRS's own internal policy. Imposing penalties where the taxpayer is already facing severe financial hardship will do nothing to further voluntary compliance. We understand that whether the taxpayer's financial condition affected the failure to pay the taxes is a question of the fact, but courts should be able to consider this factor in determining whether reasonable cause exists. The Fifth Circuit's narrow interpretation of the statute prevents courts from considering this factor.

II. TREASURY REGULATIONS ARE ENTITLED TO DEFERENCE AND THE IRS CANNOT ASSERT A POSITION THAT IS CONTRARY TO EXISTING TREASURY REGULATIONS IN ASSESSING A PENALTY

As previously noted, "reasonable cause" for a failure to pay is defined in the Treasury Regulations to include situations where the taxpayer's payment of the tax would result in undue financial hardship. 26 C.F.R. § 301.6651-1(c); 26 C.F.R. § 1.6161-1(b). Courts are not permitted to simply disregard a long-standing Treasury Regulation when interpreting a statute. In *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), the Court stated that when reviewing an agency's regulatory implementation of a statute, we look first to whether

Congress has directly spoken to the precise question at issue. *Id.* at 842. If congressional intent is clear, the courts inquiry should end, and the court should apply the unambiguously expressed intent of Congress. *Id.* at 842-843. However, if congressional intent is not clear, the question is whether the regulation is based on a permissible construction of the statute. *Id. See also Cynthia L. Rowe v. Commissioner,* 128 T.C. 13 (2007) (Treasury Regulations have the force and effect of law unless unreasonable under the statute); *Swallows Holding, Ltd. v. Commissioner,* 126 T.C. 96 (2006) (same). To include "financial hardship" as a consideration for determining "reasonable cause" is a reasonable interpretation of the statute. The Fifth Circuit should not be permitted to remove the impact of financial hardship from consideration of what constitutes reasonable cause for a delay in the payment and filing of taxes.

In addition, the IRS's own policy is to allow taxpayers to rely on published guidance. *See* 26 C.F.R. § 601.601(d)(2)(v)(e) ("Taxpayers generally may rely upon Revenue Rulings published in the Bulletin in determining the tax treatment of their own transactions and need not request specific rulings applying the principles of a published Revenue Ruling to the facts of their particular cases [where] the facts and circumstances are substantially the same."); Rev. Proc. 89-14, 1989-1 C.B. 814, § 7.01(5) (same). The courts agree that taxpayers are entitled to rely on IRS published guidance. *See Baker v. Commissioner*, 122 T.C. 143, 164 n.21 (2004) (confirming that "the public has a right to rely on positions taken by the Commissioner" in revenue rulings) (citing *Alumax, Inc. v. Commissioner*, 109 T.C. 133, 163 n.12 (1997); *Am. Campaign Acad. v. Commissioner*, 92 T.C. 1053, 1070 (1989); *Nissho Iwai Am. Corp. v. Commissioner*, 89 T.C. 765, 778 (1987)). *See also Rauenhorst v. Commissioner*, 119 T.C. 157, 182-83 (2002) ("[T]axpayers should be entitled to rely on revenue rulings in structuring their

transactions, and they should not be faced with the daunting prospect of the Commissioner's disavowing his rulings in subsequent litigation.").

In fact, the courts require the IRS to follow its own rulings. *Rauenhorst v. Commissioner*, 119 T.C. 157, 170-71 and n. 10 (2002) (Commissioner is bound by his revenue rulings); *Dover Corp. v. Commissioner*, 122 T.C. 324, 350 (2004) (following *Rauenhorst*); *Estate of* McLendon *v. Commissioner*, 135 F.3d 1017, 1024 (5th Cir. 1998) ("[T]he Commissioner will be held to his published rulings...."); *Estate of Rapp v. Commissioner*, 140 F.3d 1211, 1216-17 (9th Cir. 1988) ("[R]evenue rulings...may limit the IRS's ability to assert a position that is contrary to that asserted in the ruling if the ruling is published, to the extent that the ruling addresses a similar issue."); *Silco, Inc. v. United States*, 779 F.2d 282, 287 (5th Cir. 1986) (requiring the IRS to follow revenue rulings); *Beneficial Found., Inc. v. United States*, 8 Cl. Ct. 639, 645 n.7 (1985) ("[Revenue] rulings can provide no guidance to taxpayers if the Service and the courts fail to give them effect in litigation.").

The rationale behind limiting the IRS's ability to disregard revenue rulings is even stronger with respect to Treasury Regulations, which have received notice and comment from the public and have been published in the Federal Register. The IRS cannot disregard reliance on 26 C.F.R. § 301.6651-1(c) and 26 C.F.R. § 1.6161-1(b) and develop its own narrow interpretation of "reasonable cause." If the IRS seeks to change the regulatory definition, the change should be promulgated through new regulations.

CONCLUSION

For the foregoing reasons, *Amicus* respectfully requests that this Court grant the petition for writ of certiorari.

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No. 07-221

IN THE

Supreme Court of the United States

STAFF IT, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF OF THE TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether federal courts should consider all facts and circumstances outlined in Treasury Regulations when determining if "reasonable cause" exists to justify abatement of penalties for an employer's failure to pay payroll taxes under 26 U.S.C. § 6651(a)(2), or its failure to deposit payroll taxes under 26 U.S.C. § 6656(a).

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BRIEF OF THE TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF THE *AMICUS CURIAE*

The Tax Foundation submits this brief as *amicus curiae* in support of Petitioner in the above-captioned matter.[1]

The Tax Foundation is a non-profit research

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioner and Respondent have been obtained and filed with the Clerk of the Court.

organization founded in 1937 to educate taxpayers about sound tax policy. To this end, we disseminate information on taxes and promote tax systems that are simple, fair, and conducive to economic growth. The Tax Foundation works to further this mission by educating the legal community on issues relating to tax law, by explaining tax law concepts to lawmakers and the public in an understandable and relevant manner, and by advocating that judicial decisions on tax law promote principled tax policy. Accordingly, the Tax Foundation has a direct stake in the outcome of this case.

STATEMENT OF THE CASE

Petitioner Staff IT, Inc., engaged in the business of hiring and paying technical contractors, and staffing them to outside business clients. These clients would pay Petitioner for the services. In 2001, the dot-com crash and the collapse of Enron triggered a severe economic downturn, particularly in Houston, where Petitioner encountered reduced demand for its contractors. Petitioner's financing company also declared bankruptcy.

It was at this time that Petitioner failed for three quarters to file, pay, and deposit payroll taxes as required by federal law. Petitioner did not scale back expenses until early 2002 when new financing was arranged. The company stabilized its finances by the end of 2002 and resumed required tax payments. However, the IRS pursued penalties, which are the subject of this appeal.

Petitioner presented a request to abate the penalties, which an IRS Appeals Officer denied. Petitioner then commenced suit in the District Court, which granted summary judgment for the government. *See United States v. Staff IT, Inc.*, 2006 WL 314440 (S.D. Tex. Feb. 9, 2006). In March 2007, the United States Court of Appeals for the Fifth Circuit affirmed. *See Staff IT, Inc. v. United States*, 482 F.3d 792 (5th Cir. 2007).

SUMMARY OF ARGUMENT

Employers have an obligation to withhold payroll taxes from employees' wages and forward them to the federal government, and failure to do so properly subjects the employer to penalties. But the statute imposing this obligation allows for abatement of penalties where there has been no "willful neglect" and where the failure was due to "reasonable cause," which in turn is defined as "undue hardship."

Rather than engaging in an analysis of all facts and circumstances faced by the taxpayer, so as to determine whether there existed "willful neglect" and "undue hardship," the lower court in this case instead held that where a taxpayer fails to fire employees and cease all payments to creditors, he cannot claim "reasonable cause" or "undue hardship." This severe test is in conflict with four circuit courts of appeal, ignores the congressional purpose, and effectively reads the "reasonable cause" exception out of the statute.

Four circuit courts have held that serious financial hardship can constitute "undue hardship" justifying, in some circumstances, abatement of penalties. They have reached that result by relying on the text and on the congressional purpose, which was to deter willful failure to pay tax obligations without taking a "scorched earth" approach that forces troubled businesses to close, thus eliminating jobs, destroying investment, disrupting the economy, and ultimately, reducing tax collections.

The conduct of the Petitioner in this case, especially the failure to file, may ultimately exclude it from the benefit of the penalty abatement. But this Court should grant the petition because Petitioner is correct in arguing that the lower court used an improperly narrow test that is in conflict with the statute. If a corporation facing potential financial ruin can never be considered to have

"reasonable cause" under the statute until it fires all employees and stops all payments to creditors, the exception is virtually meaningless. This Court's guidance is needed to resolve the circuit split on this issue and to prevent harm to small businesses. The statute and regulations at issue apply nationally, and by holding that a diligent employer facing undue financial hardship—where paying the taxes necessarily means closing the business—can have penalties abated, this Court can apply a uniform standard based on the text and purpose of the statute. If the test applied by the court below stands, troubled small businesses who owe taxes and creditors will end up paying neither. This is a result that benefits no one, and a result that Congress sought to avoid.

ARGUMENT

I. THIS COURT'S GUIDANCE IS NEEDED TO APPLY A UNIFORM STANDARD BASED ON THE STATUTORY TEXT AND PURPOSE, AND PREVENT THE HARM AND UNCERTAINTY RESULTING FROM AN ACKNOWLEDGED CIRCUIT SPLIT.

Under the text of the statute and regulations, an otherwise diligent taxpayer facing undue hardship can have penalties abated in certain circumstances. Because the test used by the court below to ascertain "undue hardship" is in conflict with the text and the statutory purpose, the petition should be granted to prevent harm and uncertainty and resolve the acknowledged split in the circuit courts of appeal.

A. An otherwise diligent taxpayer facing undue hardship can have penalties abated in certain circumstances, under the text of the statutes and regulations.

The federal government requires that employers withhold 6.2 percent of an employee's wages for Social Security payroll taxes, and a further 1.45 percent for Medicare payroll taxes. *See* 26 U.S.C. § 3101. These so-called "trust fund taxes" must be forwarded to the IRS, and an employer who fails to do so can be made personally liable, even in bankruptcy. *See* 26 U.S.C. § 6672(a); 11 U.S.C. § 523(a)(1)(A). In addition to the 7.65 percent in trust fund taxes, employers have the legal obligation to pay to the IRS a further 7.65 percent "employer match." *See* 26 U.S.C. § 3111.

Federal law imposes three major sets of penalties on employers who are late in their payroll tax obligations. Late filing of payroll taxes, or failure to file, is subject to a 5 percent per month penalty up to a 25 percent maximum. *See* 26 U.S.C. § 6651(a)(1).[2] Late payment of payroll taxes, or failure to pay, is subject to a 0.5 percent per month penalty up to a 25 percent maximum. *See* 26 U.S.C. § 6651(a)(2). Late deposit of payroll taxes, or failure to deposit, is subject to a 10 percent penalty if the deposit is more than 15 days late. *See* 26 U.S.C. § 6656(b).

The statute provides that the penalties do not apply in certain situations. *See* 26 U.S.C. § 6651(a)(2) (penalty for failure to pay or late payment added "unless it is shown that such failure is due to reasonable cause and not due to willful neglect"); 26 U.S.C. § 6656(a) (penalty for failure to deposit or late deposit added "unless it is shown that such

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[2] Petitioner does not contest the penalty for late filing. The court of appeal failed to address whether this fact is relevant for a "willful neglect" inquiry.

failure is due to reasonable cause and not due to willful neglect"). *See also* 26 U.S.C. § 6656(a)(1) (penalty for failure to file or late filing added "unless it is shown that such failure is due to reasonable cause and not due to willful neglect").

Under the statute, taxpayers must show that there is both "reasonable cause" and the absence of "willful neglect,"[3] so a judicial understanding of these terms is central to determination of penalty cases. "Reasonable cause" with respect to failure to pay is defined in the Treasury Regulations:

> A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either *unable to pay the tax or would suffer an undue hardship* (as described in Sec. 1.6161-1(b) of this chapter)[4] *if he paid on the due date.* In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, *consideration will be given to all the facts and circumstances of the taxpayer's financial situation*, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such

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[3] "Willful neglect" is neither defined in the Regulations, nor was it addressed by the court of appeal.

[4] The referenced section states that undue hardship "means more than an inconvenience to the taxpayer." *See* 26 C.F.R. § 1.6161-1(b). The regulation gives the example of selling a property at a sacrifice price on the tax due date.

> expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax.

26 C.F.R. § 301.6651.1(c) (emphasis added). The regulation addressing late deposit, 26 C.F.R. § 301.6656, does not define reasonable cause, but courts (including the court below in this case) have applied the same "undue hardship" and "all the facts and circumstances" test, from the late payment regulation, in such situations. *See, e.g., Staff IT,* 482 F.3d at 800; *Fran Corp. v. United States*, 164 F.3d 814, 816 (2d Cir. 1999); *East Wind Indus., Inc. v. United States*, 196 F.3d 499, 504 (3d Cir. 1999).

As a practical matter, the statutes and Treasury Regulations only require the exercise of ordinary business care and prudence, not the exercise of extraordinary or retrospectively perfect care and prudence. As such, the statutory and regulatory text provide that after a court considers all relevant facts and circumstances, it may order abatement of penalties where a taxpayer is not guilty of willful neglect and would have reasonably suffered an undue hardship by paying or depositing payroll taxes on time.

B. The test used by the court below to determine "undue hardship" conflicts with the regulatory text, congressional purpose, and the conclusions of other courts.

Instead of applying an "all facts and circumstances" approach, the Fifth Circuit focused on whether specific acts of conduct occurred. The court held that unless a taxpayer has fired "enough" employees, and if the taxpayer has "favored" creditors over the government, the taxpayer's conduct can never amount to reasonable cause.

The court did note that the regulations instructed consideration be given to all facts and circumstances of

the taxpayer's financial situation. *See Staff IT*, 482 F.3d at 799. However, the court declined to adopt the test. *Id.* at 800 ("We . . . need not—and therefore do not—resolve this issue today."). Instead, the court applied a dispositive analysis of only two factors:

> [T]he jurisprudence reflects that the primary factors in determining whether a taxpayer exercised ordinary business care are (1) the taxpayer's favoring of other creditors over the government, which weighs against a finding of reasonable cause, and (2) the taxpayer's willingness to decrease expenses and personnel, which weighs in favor of a finding of reasonable cause.

Id. at 801. Therefore, in the view of the lower court, unless a taxpayer (1) ends all payments to all creditors *and* (2) fires "enough" employees, the taxpayer's non-compliance will be considered to have been due to willful neglect and not reasonable cause.

Neither the regulations nor the statute require that "enough" employees must be fired for reasonable cause to exist. The court does not provide authority for its conclusion. *Fran Corp.*, to which the court cites in a footnote, does not discuss the firing of employees, but rather "lavish or extravagant" entertainment expenses. *Fran Corp.*, 164 F.3d at 820. Courts can, of course, consider staffing levels as part of a consideration of all facts and circumstances in the case. But the lower court's dispositive focus on whether people were fired, while declining to consider other facts or circumstances, has no basis in the law.

The other element of the Fifth Circuit test, whether a taxpayer favors other creditors over the government, guarantees that no taxpayer suffering financial hardship can ever prevail. When a business continues to operate

but defaults on its tax obligations, other creditors *necessarily* are favored over the government. Even a taxpayer who pays only those expenses necessary for staying in business would fail the Fifth Circuit's test. The Fifth Circuit understands the harshness of this test, but pointed to the importance of preventing businesses from escaping their tax obligations. "To conclude otherwise would be to sanction S.I.'s unilateral, self-execution of a government loan." *Id.* at 801-02.

Preventing businesses from engaging in such conduct is certainly very important, but it is a policy choice to which Congress has created an important exception. While the default position is to impose penalties on those who fail to deposit and pay payroll taxes, the "reasonable cause" and "willful neglect" provisions in the statute show Congress's expectation that there are situations where penalties will be abated. Under the Fifth Circuit test, where a business must end all payments to all creditors and must fire "enough" employees, a business must necessarily go out of business. "Under this approach, no one benefits. Where, however, a taxpayer keeps its business operating at a minimal level in order to collect monies contractually due so that it can pay trust fund taxes and other debts . . ., the economy and the federal fisc, including the IRS, benefit." *East Wind Ind.*, 196 F.3d at 509.

The implicit Fifth Circuit test closely resembles the explicitly adopted test of the Sixth Circuit Court of Appeals in *Brewery, Inc. v. United States*, 33 F.3d 589 (6th Cir. 1994). There, a business failed to deposit and pay payroll taxes after suffering lost business due to a nearby bridge construction project. *See id.* at 591. The court held that use of the withheld taxes for business purposes automatically precluded a finding of reasonable cause. "[S]ince the trust fund taxes are for the exclusive use of the government, the use of trust funds for the payment of other creditors cannot, as a matter of law,

constitute reasonable cause for abating the penalties assessed. . . ." *Id.* at 592.

The *Brewery* rule has been heavily criticized by four other circuit courts of appeal. These cases, particularly the later ones, have acknowledged the split in authority and explicitly declined to follow the *Brewery* rule. In *Diamond Plating Co. v. United States*, 390 F.3d 1035, 1038 (7th Cir. 2004), the Seventh Circuit concluded that financial hardship can justify abatement of penalties, referring to appellant's argument that the company "would have been forced out of business or into bankruptcy if it had paid the 1998 and 1999 employment taxes." *Id.* at 1038. *See also id.* ("We agree with the majority of circuits that have considered this issue, and recognize that financial hardship may constitute reasonable cause for abatement of penalties for nonpayment of taxes in some circumstances."). However, after reviewing all relevant facts and circumstances, *see id.* at 1038-39, the court concluded that Diamond Plating's non-compliance did not stem from reasonable cause. Specifically, the company had paid its taxes during its financial low point in 1996, and failed to do so in better times in 1998-99 primarily because of a deceptive accountant. Because the company paid its arrears immediately after the deception became known, "[this] suggests that the company had an available source of credit in times of financial difficulty. In light of these facts, no reasonable jury could find that Diamond Plating's financial situation excused its failure to pay employment taxes in 1998 and 1999." *Id.* at 1039. Nevertheless, the *Diamond Plating* court explicitly rejected the *Brewery* rule and held that financial hardship can constitute reasonable cause for abatement of penalties.

In *Van Camp & Bennion v. United States*, 251 F.3d 862 (9th Cir. 2001), the Ninth Circuit also considered and rejected the *Brewery* rule. The trial court had refused to

consider any conduct outside of eight IRS-listed situations as reasonable cause, a ruling the Ninth Circuit considered "clearly erroneous." *Id.* at 867. The court ruled that if a business must choose between paying taxes and staying in business, it can constitute reasonable cause. "The need to reject *Brewery*'s bright line rule is illustrated by the facts of this case. . . . If the potential ruin of a corporation is not relevant, then the reasonable cause exception is virtually meaningless." *Id.* at 868. The court remanded the case to the trial court for determination of all facts and circumstances, including the business's financial problems. *See id.* at 867-69.

In *Fran Corp.*, the Second Circuit held that the "regulations clearly require a factual assessment of the taxpayer's financial situation to determine whether it has exercised ordinary business care and prudence in responding to competing financial obligations." *Fran Corp.*, 164 F.3d at 819. Application of the test includes ascertaining whether expenses made in lieu of paying due taxes were necessary to sustain the business. "[T]hese expenditures support the district court's finding that they were 'lavish or extravagant' because the preservation of the business did not require them to be made. *Id.* at 820, *citing* 26 C.F.R. § 301.6651-1(c)(1). Responding to the *Brewery* rule, the Court rejected the view that financial distress can never amount to undue hardship. "To hold otherwise would effectively read out of the statute the 'reasonable cause' exception to mandatory penalties in many employment tax cases." *Id.* at 819.

In *East Wind Ind.*, the Third Circuit held that if a review of all facts and circumstances demonstrate that the business would necessarily have closed had payment of taxes occurred when due, even if other creditors received payments, reasonable cause exists justifying abatement of penalties:

> The evidence shows that if the Taxpayers had paid their employment taxes when due,

> they would have had insufficient funds to pay the reduced work force and essential creditors to enable them to remain a going concern. . . . Under these facts and circumstances, we find that the Taxpayers have established that undue hardship would have resulted if they had paid their employment taxes on time.

East Wind Ind., 196 F.3d at 509-10.

The *East Wind* court also stated some of the reasons underlying the congressional decision to permit abatement of penalties. "The IRS has consistently taken the position that if a taxpayer cannot afford to pay trust fund taxes, no matter what the cause, it should close up shop. Both the economy and the federal fisc are negatively impacted by such an approach—the amount of money flowing into the economy and the fisc is reduced as a result of increased unemployment, idle buildings and plants, and decreased sales of goods and services." *Id.* at 509. The rule applied by the Fifth Circuit, that a business suffering financial hardship must end all payments to all creditors and must fire "enough" employees in order for there to be "reasonable cause" justifying abatement of penalties, undermines this congressional purpose and is in conflict with the statute, regulations, and the conclusions of four sister circuits.

C. The petition should be granted so as to provide guidance and prevent harm and uncertainty.

The statute and regulations at issue apply nationally and have long existed. "The 'reasonable cause'/willful neglect' standard has been a part of the penalty provisions of the tax statutes since 1916, and Congress has not amended these provisions to create a different standard for the failure to pay trust fund taxes. . . ." *Fran*

Corp., 164 F.3d at 818. The regulatory language describing the "all the facts and circumstances" test, 26 C.F.R. § 301.6651-1, and the consideration of "undue hardship," 26 C.F.R. § 1.6161-1(b) have existed since 1973. Substantial reliance exists on the statute and regulations being upheld by the IRS and by courts.

In the Sixth Circuit and now the Fifth Circuit, troubled small businesses who owe taxes and creditors now face an unenviable set of options. They can pay their taxes, and if that necessarily means closing the business, investment will be lost, employees fired, and capital idled. This is despite congressional awareness of the sad irony of using penalties to collect Social Security and Medicare taxes on behalf of employees who are then terminated. Alternatively, a business facing undue financial hardship can keep the doors open, but to qualify for abatement of penalties, it must refuse to pay all creditors and begin firing employees. Most if not all businesses in financial distress will be unable to qualify for the abatement specifically granted by Congress.

In four other circuits, an otherwise diligent employer who faces the choice of paying taxes or closing his business can have penalties abated in certain circumstances. Following the letter of the statute and regulations, the court must examine all relevant facts and circumstances in making this determination. The presence or absence of any one element is not dispositive or conclusive.

Therefore, the meaning of a federal statute and federal regulations intended to have national scope will vary by region. Instead of the uniform application anticipated by Congress, troubled businesses will face harsher treatment in the Fifth and Sixth Circuits than elsewhere, making business investment potentially less profitable there than in other circuits. This harm is particularly unjustified when considering the text and purpose of the statute and regulations.

This Court should grant the petition to resolve this circuit split, remedy this uncertainty and uneven application of a national law, and uphold the congressional text and the meaning and purpose behind it. Although this Petitioner's conduct in failing to file may be relevant for denying it an abatement, such a conclusion can occur only after application of the proper comprehensive test. The court below did not do so, and instead adopted an improperly narrow test that forces troubled small business to close, depriving creditors of what they are owed, depriving employees of their jobs, depriving investors of their returns, disrupting the economy, and ultimately, depriving the government of future tax revenue. This harm is a result that benefits no one, and a result that Congress sought to avoid.

CONCLUSION

For the foregoing reasons, *Amicus* respectfully requests that this Court grant the petition for writ of certiorari.

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